

Revitalizing America

Office of the Chief Investment Strategist

Debt ceiling deal: *The end of the beginning*



Publication details

Publisher

UBS Financial Services Inc.
1285 Avenue of the Americas, 13th Floor
New York, NY 10019

This report has been prepared by
UBS Financial Services Inc. ("UBS FS")
and UBS AG. Please see important disclaimer
and disclosures at the end of the document.

This report was published on
2 August 2011.

Editor in chief and author

Katie Klingensmith

Contributors (in alphabetical order)

Thomas Berner
Anne Briglia
Stephen Freedman
Katherine Klingensmith
David Lefkowitz
Peter Rowan
Mike Ryan
Mona Sutphen
Jeremy Zirin

Editor

Marcy Tolkoff

Desktop Publishing

George Stilabower

Project Management

Paul Leeming
Courtney McCarthy

Contents

Introduction	1
Chapter 1	
Washington had to start somewhere.....	2
Chapter 2	
Budget deal will not choke off growth.....	4
Chapter 3	
A first step.....	6
Conclusion	8

What is Revitalizing America?

The Revitalizing America initiative was created to directly address the issues that are foremost on clients' minds today, such as the national debt, value of the dollar, unemployment, taxes and inflation.

To provide our clients with relevant insights and direction, UBS Wealth Management Americas has produced a series of informative publications addressing these topics, drawing on UBS' global expertise and relationships.

UBS is also partnering with influential leaders, including President Clinton and President George W. Bush, to get their perspectives on these issues and discuss strategies to restore America's competitiveness.

On the evening of August 2, Bob McCann, CEO of UBS Wealth Management Americas, sat down with Presidents Clinton and Bush to discuss many of these issues. Please feel free to ask your Financial Advisor for an Executive Summary of that presidential conversation.

Additionally, UBS, working with the Clinton Foundation, is launching the CEO-UBS Small Business Advisory program, a financial advisory mentorship program aimed at providing small business owners in underserved communities with the knowledge and skills necessary to support business expansion and job growth.

To stay close to what our clients are thinking, UBS regularly conducts national surveys of individual investors. In our most recent survey, the uncertainty over the debt ceiling negotiations and the towering national debt was of paramount importance.

We believe that the best thing we can do during uncertain times is to increase our understanding, which is why we developed this report. Understanding these issues from both political and market vantage points allows us to see how the recent agreement on the budget and debt ceiling could potentially impact our lives and our portfolios.

We encourage you to speak with your Financial Advisor to explore what all this may mean for you and your long-term investment strategy.

Introduction

Mona Sutphen, UBS Wealth Management Global CIO Team, UBS AG; **Katie Klingensmith**, Strategist, UBS Wealth Management Research

In the end, no surprises...

After all of the brinksmanship, the Congress and the White House enacted a USD 2.4 trillion deficit-cutting package, lifting the debt ceiling and averting default. The 74-page law includes a path to increase the debt ceiling through the end of 2012 in phases — USD 900 billion initially, in two phases, and another USD 1.2 trillion upon request by the president.

The legislation caps both discretionary spending, saving USD 917 billion over 10 years (with approximately USD 350 billion in defense program cuts), and fiscal year 2012 spending at USD 1.043 trillion. Further, a new 12-person bicameral, bipartisan “Joint Select Committee” (JSC) will be tasked with identifying an additional USD 1.5 trillion in deficit reduction, including entitlement savings and tax increases. If the panel fails to act by 23 November 2011 (or the Congress does not approve the proposed savings within one month), it will trigger automatic spending cuts of USD 1.2 trillion over 10 years, starting in 2013. This “sequestration” mechanism was borrowed from the 1987 Gramm-Rudman-Hollings Balanced Budget Act, and will exempt Social Security, Medicaid as well as veterans’ and military pay from automatic cuts. As UBS’s US economist Thomas Berner explores in the following pages, the uncertainty generated by the different phases of deficit reduction and the “back-ended” nature of the cuts mean that there is some risk they will not be fully implemented. It is, however, reassuring that the cuts are not to be aggressively imposed quite yet, as the economic recovery has recently shown signs of faltering and government spending was already set to be reduced.

No sigh of relief

Though the immediate crisis has been averted, no one in Washington is fully satisfied with the outcome and the tough fiscal decisions remain unaddressed. The fiscal year 2012 discretionary budget cap and inclusion of a JSC mechanism guarantee the debate will continue for the next 18 months (though without the risk of default).

Peter Rowan from the UBS US Office of Public Policy outlines the different battles that will unfold as Washington will continue to focus on the size of government and how it is funded. While the law passed this week provides a credible framework to achieve deficit reduction, there are many tough decisions to be made and numerous ways the planned cuts could be undermined as it gets closer to 2013. In the end, the determining factor has and will continue to be whether the nation’s political leadership has the will to address the country’s unsustainable fiscal path.

While many important unanswered questions remain, including the nature, timing and ultimate size of the second phase of cuts, market reactions to both the House and Senate passage were trumped by slumping economic growth concerns. Averting default is a relief, and below our strategists explore what it may mean for markets going forward. Rating agencies likely remain concerned about the long-term fiscal trajectory of the US government. Though the risk of downgrade has receded somewhat, if it were to occur, it could send Treasury yields higher; however, we doubt that the move would be catastrophic to growth or government finances. Our strategy team outlines how even with fiscal issues remaining a battleground, equity markets are poised to do well, at least relative to holding bonds. Now that a default has been dodged, markets can focus on economic and corporate fundamentals.

The dysfunction and disarray of Washington has been disheartening, at best. But the small silver lining may be that the much-needed national debate about the nature and scope of the role of the federal government — and the means to pay for it — will be a central focus of the 2012 presidential election.

Chapter 1

Washington had to start *somewhere*

Peter Rowan, UBS Office of Public Policy

Now that a default has been avoided, let's consider what the Budget Control Act of 2011 means for Washington over the next six months. Policymakers will first take a breather and leave town for a long-cherished August recess. Upon return to Washington in September, however, the legislative wheels will be put into high gear in order to meet a number of deadlines contained in this week's deal, and the debates about the size and funding of the government will remain front and center.

August – September

With the debt ceiling raised and spending caps established, the next step will be to name members of the newly created JSC, tasked with identifying an additional USD 1.5 trillion in deficit reduction. Look for the committee to be appointed quickly and to be evenly divided not only along party lines but among those who will agree to tax increases and those who will not. This makeup will likely eliminate the threat of direct tax increases in any proposal but leaves the door ajar for "tax reform," i.e., eliminating tax expenditures and reducing income tax rates. Of course tackling tax reform in three months is an incredibly steep hill to climb.

The Budget Control Act allows for Congress to disapprove of a debt limit increase beyond USD 400 billion, the initial increase allowed under the bill. Note that the USD 900 billion increase in the bill does come in two tranches, and after the USD 400 billion has been exhausted, we will likely see this vote of disapproval. However, the bill also allows the president to veto congressional disapproval, so while we expect to see additional votes on the debt limit as early as September and again in January, it is an exercise in politics that should not threaten a default.

October

While the JSC begins its work behind the scenes, the

annual fight over how to allocate funding for government programs will be waged publicly and feed media speculation over yet another threat of a government shutdown. The federal government's 2012 fiscal year starts on 1 October 2011, at which point lawmakers need to agree on spending levels for all federal programs. The yearly spending battle in Washington is usually over *how much* to spend but an FY 2012 spending cap was set in this week's deal. Lawmakers will still get to argue over *how to allocate* that funding, but perhaps the spending limit will serve to temper the debate.

While the debt ceiling has been lifted, default avoided and congress vacated for the remainder of August, the second half of 2011 will be as full of spending battles and partisan tensions as the first.

November – December

By Thanksgiving, we will know whether the new JSC has produced a deficit reduction plan or has been paralyzed by partisan fights. 23 November 2011 is the due date for its plan, and both the House and Senate will have until December 23 to accept or reject it without change.

Before the end of the year, the Budget Control Act also requires Congress to vote on a constitutional amendment



that would require a balanced budget. In order to amend the Constitution, both chambers need to approve the amendment with a two-thirds majority. We do not expect the amendment to pass Congress this year, but if it did then three-fourths of the states would need to ratify it. This process of gaining approval in the states could take a number of years.

January

Should the JSC fail to submit a deficit reduction bill of at least USD 1.2 trillion, or should Congress fail to approve the committee's recommendations, automatic spending cuts of USD 1.2 trillion would be set in motion. This trigger will also allow the president one more increase in the debt limit, likely to last beyond the 2012 election.

While the debt ceiling has been lifted, default avoided and congress vacated for the remainder of August, the second half of 2011 will be as full of spending battles and partisan tensions as the first. Stay tuned: Decisions made this week to cut spending levels will soon materialize as federal program cuts. Washington will certainly struggle with the implementation of this law for years to come but it had to start somewhere. At least a small down payment on stabilizing the overall federal debt has been made.

Chapter 2

Budget deal *will not choke off growth*

Thomas Berner, CFA, US Economist, UBS Wealth Management Research

The Budget Control Act of 2011 cuts the US deficit by at least USD 2.1 trillion over the next 10 years. The deficit reduction will come in two phases: the first is comprised of USD 917 billion in spending cuts while the form and magnitude of the second phase will be determined by the congressional committee (JSC). The two-tiered process makes it hard to assess the overall economic impact. In our view, there is no growth impact from the first phase in 2011 and it is negligible in 2012, but the second wave of cuts could cause a bigger, but manageable, impact.

Spending cuts are back-loaded

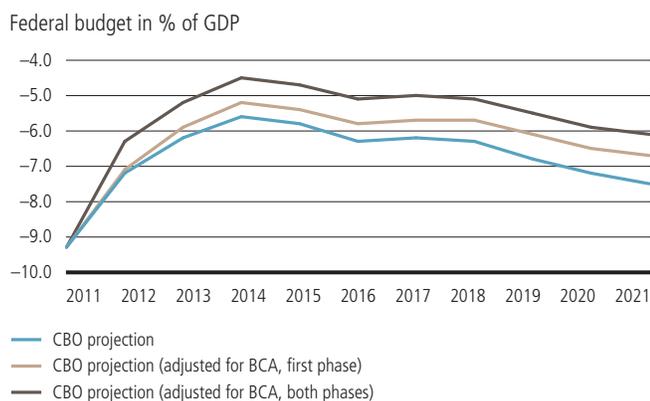
According to the Congressional Budget Office, the Budget Control Act of 2011 involves deficit reduction that is “back-end loaded,” as the majority of the cuts take place toward the end of the next 10 years, in part because lower deficits imply lower cumulative interest payments. Figure 2.1 shows the CBO’s estimates of the fiscal scenario including and excluding the first phase of cuts, which

widens the more we look into the future. In our view, this is a good thing, as front-loaded spending cuts could choke off a fragile recovery.

Growth impact in 2011 and 2012 is negligible

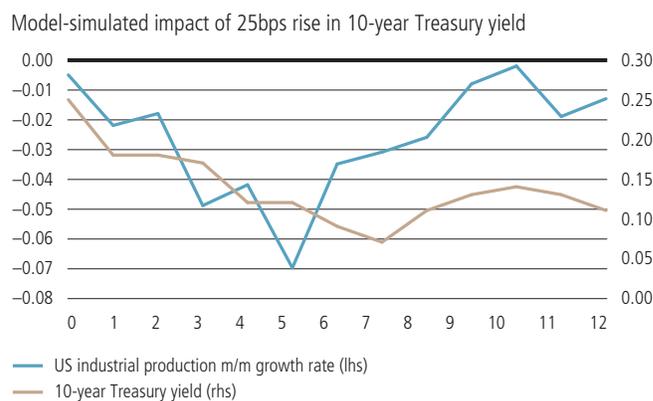
The impact on fiscal year 2011, which ends in September 2011, is estimated to be zero. The impact in fiscal year 2012 is USD 21 billion or about 0.1% of nominal GDP, a mere rounding error. We therefore do not worry that the first phase of deficit reduction will weigh heavily on growth. As the second phase of deficit reduction will at a minimum be USD 1.2 trillion over 10 years, set in motion by December 2011, we assume deficit reductions of USD 120 billion annually starting in fiscal year 2012. Figure 2.1 shows how the fiscal scenario looks when we add these additional savings. A total USD 141 billion hit to growth or about 0.7% of GDP in fiscal year 2012 would be harder to digest, but still manageable in our view. Furthermore, the second phase of cuts will also likely be more

Fig. 2.1: Deficits to remain high



Note: BCA means Budget Control Act of 2011. The first phase is savings of USD 917bn, the second are savings of at least USD 1.2tn over 10 years
Source: Congressional Budget Office, UBS WMR, as of 1 August 2011

Fig. 2.2: A small rise in bond risk premium is not too detrimental



Note: The lines reflect the deviation from previous growth (for industrial production) and from the previous level (for 10-year yield)
Source: Congressional Budget Office, UBS WMR, as of 1 August 2011

back-end loaded than we have assumed in Fig. 2.1, mitigating the drag on the economy in 2012. For comparison, we currently expect a deficit reduction of USD 300 billion in fiscal year 2012 compared to the previous year as the unemployment benefits extension and payroll tax credits expire and tax collection growth improves further. Even with this headwind we still expect 2.3% growth in 2012.

In addition, the contentiousness of the debt ceiling-budget debate, the apparent omission of growth-enhancing reforms and the back-loaded nature of the spending cuts (which raises the odds that the political will to carry out unpopular cuts may fade), suggest to us that the credit rating agencies may be dubious about the seriousness of reform.

Moderate growth impact from a ratings downgrade

In our opinion, the odds of a one-notch downgrade by at least one rating agency remains higher than 50%. Although the rating agencies may wait until the third quarter for the JSC proposals, the total size of the deficit reduction package is well below the USD 4 trillion in cuts that S&P originally suggested would be consistent with a AAA rating. Given that debt-to-GDP will continue to increase even with these cuts, the contentiousness of the debt ceiling-budget debate, the apparent omission of growth-enhancing reforms and the back-loaded nature of the spending cuts (which raises the odds that the political will to carry out unpopular cuts may fade), suggest to us that the credit rating agencies may be dubious about the seriousness of reform.

In the event of a downgrade from one of the major rating agencies, it's likely that Treasury yields would rise slightly to embed a higher credit risk premium. We estimate an approximate increase of 25 basis points in the 10-year Treasury yield, resulting in a very small impact on economic growth. Figure 2.2 shows the possible growth impact on US industrial production. Relative to the prior growth trend, a jump of 25 basis points in the 10-year Treasury yield would depress month-over-month industrial production growth by a maximum of 0.07% versus the long-term trend of 0.16%. After about 10 months, the prior trend would have been restored. Higher interest rates do compound, however, thereby increasing the amount of debt and servicing cost of the debt held by the US Treasury.

Chapter 3

A first *step*

Stephen Freedman, PhD, CFA, Strategist, UBS Wealth Management Research; Anne Briglia, CFA, Strategist; Jeremy Zirin, CFA, Strategist

From an investment perspective, the Budget Control Act can be viewed as an inflection point in dealing with federal deficit challenges and a moderate positive for risk assets such as equities. The agreement's main benefit is that it removes the risk of a catastrophic default by Treasury. While this was viewed by many as an unlikely tail risk, its prospects were nonetheless significant enough to weigh on the sentiment of investors, consumers and businesses alike.

By removing the threat of a default due to the debt ceiling until after the 2012 presidential election, the deal allows financial market participants to shift their focus back to economic fundamentals, although we do not expect that fiscal debates are behind us. While politicians will have to deliver on their commitments and likely have to engage in further fiscal consolidation down the road, this agreement may very well mark a positive turning point in the market's perception of the US debt trajectory.

Nonetheless, various uncertainties about fiscal policy

may continue to weigh on markets over the next several quarters.

- As discussed by Peter Rowan, many spending decisions remain unresolved, not the least of which are the deficit savings prescribed by the congressional JSC and the fiscal year 2012 budget debate.
- Second, the risk that Treasury debt will be downgraded by one or more rating agencies will remain a source of uncertainty. As outlined by Thomas Berner, we expect 10-year Treasury yields to rise by 25 basis points if the US credit rating is reduced by one notch. We do not expect a substantial selloff in Treasuries or the US dollar because there are currently no sufficiently deep or liquid markets that serve as alternatives.
- Finally, the extent of fiscal contraction that will be imposed on the US economy in 2012 will be an important market driver. With the economy having hardly grown in the first half of the year and GDP growth not

Fig. 3.1: Equity valuations are attractive



Source: Datastream, IBES, UBS WMR, as of 1 August 2011

Fig. 3.2: Bond yields near all-time lows



Source: Bloomberg, UBS WMR, as of 1 August 2011



While politicians will have to deliver on their commitments and likely have to engage in further fiscal consolidation down the road, this agreement may very well mark a positive turning point in the market's perception of the US debt trajectory.

expected to exceed 2.5% in the second half, a market-friendly outcome would involve limited front loading of the announced spending cuts. Therefore, the specifics of the second tranche of deficit reduction proposals are important.

Despite these open issues, we currently see better return potential for equities than bonds. We expect that earnings growth will remain the main driver of equity returns going forward, while P/E multiple expansion is likely to have a limited role given ongoing macroeconomic and fiscal policy-related uncertainties. Yet, with equity valuations at unusually low levels — the S&P 500 P/E is about 20% below its 25-year average (see Fig. 3.1) — a significant amount of macroeconomic risk appears to already be priced into the market, thereby limiting any downside. Moreover, despite sluggish economic growth, the corporate earnings picture has stayed supportive and is expected to continue to remain so in the next several quarters. Companies have beaten earnings expectations in 2Q and, perhaps more importantly, have not set the bar very high for 3Q earnings. In contrast, we do not view bonds as attractive at current yield levels. We do not expect a significant bond market selloff, even in the event of a ratings downgrade given the delayed prospects for Federal Reserve tightening. Nonetheless, we believe that bond investors are not adequately being compensated for longer-term inflation risks. The dollar too could face further pressure from fiscal concerns, but we think it will not see precipitous declines.

Conclusion

Katherine Klingensmith, Strategist, UBS Wealth Management Research

While raising the debt ceiling came down to the wire, we may look back at this moment and reflect that it was only now that Americans began to take managing the debt seriously. The debate about the size and role of government is far from over. Not only will there be repeated decisions and votes as part of the Budget Control Act of 2011, but we expect fiscal issues to be at the core of the 2012 elections. Many of the difficult cuts and decisions are not set to occur for years, even under the current plan.

Even though this agreement does not put the US government finances on a permanently sustainable path, we do think there is growing political will to begin to “bend the curve” of rising federal debt and to rethink how government pays for and offers many services. While the credit rating agencies may not move to downgrade the US credit rating just yet, their vigilance will remind those in politics and in markets that there is much more to be done. Even with the threat of default gone, we think investors will remain acutely concerned about government debt in the US and around the world. With the US economy looking increasingly fragile, there is no easy way out of deficit spending. However, if this week’s plan is implemented and more fiscal reform comes our way as is expected — with the bulk of the deficit reduction taking place when the economy has more momentum — we expect US assets will continue to generate attractive returns over time.

Disclaimer

This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other special product. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS and its affiliates). All information and opinions as well as any prices indicated are currently only as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria. At any time UBS AG and other companies in the UBS group (or employees thereof) may have a long or short position, or deal as principal or agent, in relevant securities or provide advisory or other services to the issuer of relevant securities or to a company connected with an issuer. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in FX rates may have an adverse effect on the price, value or income of an investment. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we would recommend that you take financial and/or tax advice as to the implications (including tax) of investing in any of the products mentioned herein. This document may not be reproduced or copies circulated without prior authority of UBS or a subsidiary of UBS. UBS expressly prohibits the distribution and transfer of this document to third parties for any reason. UBS will not be liable for any claims or lawsuits from any third parties arising from the use or distribution of this document. This report is for distribution only under such circumstances as may be permitted by applicable law.

USA: Distributed to US persons by UBS Financial Services Inc., a subsidiary of UBS AG. UBS Securities LLC is a subsidiary of UBS AG and an affiliate of UBS Financial Services Inc. UBS Financial Services Inc. accepts responsibility for the content of a report prepared by a non-US affiliate when it distributes reports to US persons. All transactions by a US person in the securities mentioned in this report should be effected through a US-registered broker dealer affiliated with UBS, and not through a non-US affiliate.

© UBS 2011. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

Member SIPC. All other trademarks, registered trademarks, service marks and registered service marks are of their respective companies.

www.ubs.com/financialservicesinc

UBS Financial Services Inc. is a subsidiary of UBS AG.

