

Wallace's Daily Policy Debrief

Today:

- 1) 2013 Outlook – Kim Wallace
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2013 Outlook: What's Washington Likely to Do?

The range of possible policy outcomes this year is wider than any time in the past decade. “Just about everything,” answers the “what’s different?” question. The most recent U.S. economic downturn has loosened its grip on fiscal policymaking in measurable and tangible ways. U.S. instigation of geostrategic conflict, which mightily contributed to deficits in the past decade, is waning considerably. Divided government seems less likely to replicate the crisis mentalities of 1994-1996 or the past two years.

Demography has pushed to the fore as the catalyst for partisan discord. **Policies addressing myriad aspects of immigration, domestic violence, education, employment, and civil rights are basically social policy debates.** Some contain elements of fiscal policy (health care and consumer protection, for example), but most of these subjects broached in the President’s inaugural address lack immediate market implications. **The ‘small ball’ policy environment notion we discussed last week forces a wider range of possible Washington policy outcomes.**

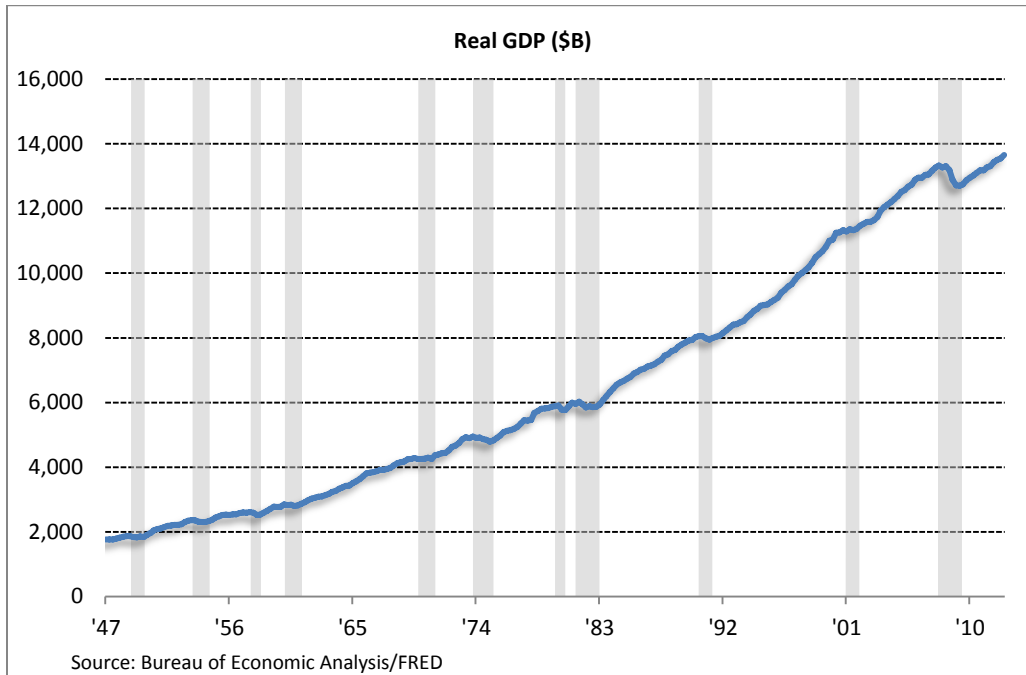
A small ball lens also applies to sector policies, to which we continue to believe the 113th Congress and the Obama Administration will give attention.

- **Housing policy** is no longer driven mainly by crisis; buyers, sellers, renters, and investors are increasingly putting money to work. A restructuring of rules governing origination, federal subsidies, mortgage access, securitization, and liquidity would allow for more efficient investment analysis and remove taxpayers from first loss position.
- **Energy** is adding to job creation and diminution of geopolitical risk. Those trends likely will be supported by Washington, even as environmental protection remains a priority.
- **Financial sector** regulation replaces crisis management and legislation as the primary top-down factor managers and investors need to watch (we continue to assign <50% odds to legislation revising Dodd-Frank during this Congress).
- **Healthcare reform** will be a feature of federal policymaking for at least another decade. Our sense is major inflections in the process will have long lead times, phase-ins, and other opportunities for reasoned stakeholder adjustments to the necessary, incremental progress of policy’s accommodation of demography.

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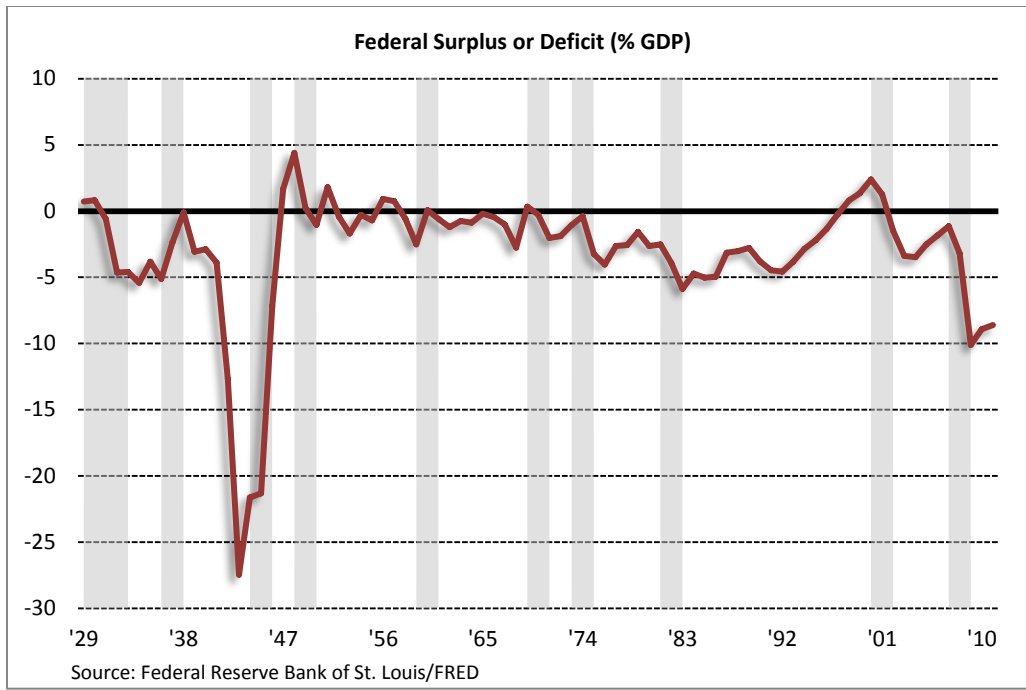
Our 2013 policy outlook is underpinned by assumptions that the worst of the most recent recession is behind us, and that the American apex of mortal and other resource expenditure in foreign war also has passed. The following graph is an unpretentious representation of U.S. economic resilience. For much of the past 65 years, the U.S. has realized fairly steady growth.



Policy matters, of course, but it matters most in times of stress. Otherwise, policy is one of several inputs in economic activity and most often not the most consequential. Washington has a ways to go before resolving long-known fiscal challenges, but that process should not derail U.S. economic recovery. The odds of self-imposed macroeconomic disaster are as low as it has been in two decades, certainly no higher. Public opinion, realistic risk assessments, and current political leadership also greatly reduce odds of new, massive foreign deployments of expensive U.S. military assets. Those two factors are highly unlikely to provide downside surprise to U.S. fiscal balances.

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As seen in the foregoing graph, from 1952 through 2001, U.S. annual fiscal balances ranged between a surplus of 2.5% and deficit of 5% as a measure of GDP. Policy was a main ingredient in world war deficits as well as the credit bubble deficits from which the U.S. continues to steadily repair. **Returning to a tighter range and annual results that tilt closer to balance or better can be accomplished by small ball installments, as has been the case the past two years.**

Policy management by divided government most worries markets when urgent decisions are required. Geopolitical risk management is a constant part of the policy landscape for G50 countries. The same obviously is true of macroeconomic policy management. **But for the foreseeable future, governance in Washington is poised to enjoy the luxury of wider horizon decision-making in these core areas of constitutional responsibility as endemic crises abate.**

For this reason, we firmly believe that Washington currently is at worst a neutral factor in near-term risk-adjusted investment analysis. In fact, from a thematic basis, we see growing possibilities that Washington could become a constructive variable in business and portfolio managers' decisions on where to put money to work.

- Kim Wallace

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Policy Calendar

Wednesday

- 3am EST, the World Economic Forum convenes in Davos for 5 days of winter meetings
- 10am, IMF releases most recent World Economic Outlook

Thursday

- Flash manufacturing PMIs for Germany (3:30am), Eurozone (4am), and U.S. (8:58am)
- 10am EST, Kerry nomination hearing

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