CIBC Asset Management

Market Insight

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NOT SO SUPER COMMITTEE

Still reeling from the sovereign debt crisis in Europe, capital markets around the world were rocked by the disappointing, but not unexpected, failure by the U.S Super Committee to come to an agreement on deficit reduction measures after months of negotiations.

The Super Committee, or more officially, the Joint Select Committee on Deficit Reduction, was formed in August 2011 to identify deficit reduction opportunities as part of an agreement to increase the U.S. debt ceiling. The Super Committee, made up of twelve members of Congress, six Democrats and six Republicans, was charged with recommending $1.2 trillion in deficit reduction measures over ten years. A trigger mechanism has been built in to automatically cut $1.2 trillion from pre-agreed-upon programs beginning in January 2013 if the Committee is unsuccessful in brokering a deal.

The Super Committee's admission that they were not close to finding a solution is a further demonstration of the lack of political flexibility in addressing economic challenges in the U.S. The August 2011 downgrade of U.S. debt by the Standard and Poor's rating agency was based on a lack of "effectiveness, stability, and predictability" of the government. In the case of the Committee, the Republicans refused to accept tax increases while the Democrats refused to allow spending cuts to social security programs. As a result, the American people and the financial markets suffer the consequences.

The net U.S. fiscal position will not be affected by the failure of the Super Committee. While $1.2 trillion represents a meaningful amount of deficit reduction, it is important to keep in mind that the same amount of deficit reduction will occur even though the Super Committee is deadlocked and automatic spending cuts take effect. $1.2 trillion in cuts will now automatically be made to the defense budget and to domestic programs (unless the next elected Congress rejects the cuts). While a great deal of attention is being paid to the Super Committee, it is unlikely that deficit projections will change substantially following their disbandment.

While a stalemate in the Super Committee is not viewed as a positive development by the rating agencies, there is little reason to believe that they will downgrade U.S. debt based solely on a failure to agree. Rating agencies have stated that, given that they expect $1.2 trillion in planned deficit reduction to materialize through automatic cuts, their fiscal outlook should remain unchanged.

Although markets had relatively low expectations about the outcome of the Committee's progress, the market reaction will hinge on the growth impact of the measures to be adopted. For example, will they extend the expiration of the unemployment benefits and payroll tax holiday for 2012? Will the deficit cuts be back-loaded to the latter part of the ten year period or not? A failure to extend existing tax breaks combined with more front-loaded deficit cuts would have a negative impact on growth in 2012-2013. A lowering of growth forecasts would likely push bond yields and equity prices lower while triggering a general risk aversion in global markets. This "risk off" mode would push the U.S. dollar higher and commodity currencies, including the loonie, lower along with emerging market currencies.

With U.S. Treasury yields remaining at record lows, U.S. Congress lacks the political will to make tough decisions, especially in advance of 2012 elections. U.S. government leaders have not felt the same pressure to act as their European counterparts who are struggling with increasing borrowing costs and public protests. We do not expect any material progress on U.S. deficit reduction until after the 2012 elections and, therefore, we expect market uncertainty to continue.

We will closely monitor the increased risk of political uncertainty spilling over into consumer and business confidence and the possibility of this deterioration leading to a further growth downgrade to our current economic scenario.

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