MARKET INSIGHTS

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Dr. David Kelly, CFA
Managing Director
Chief Global Strategist
J.P. Morgan Funds

David M. Lebovitz
Associate
Global Market Strategy Team
J.P. Morgan Funds

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Understanding the Sequester

A recent survey conducted by The Hill found that only 36% of likely voters even knew what the term "sequester" meant[1]. For the record, "sequester" in our current fiscal lexicon, refers to the $1.2 trillion of spending cuts spread out over the next 10 years that are set to commence on March 1, 2013. These cuts have the potential to impact both the markets and the economy. Although time still remains for a deal to be reached, it seems increasingly unlikely that this will actually occur, making it more likely that the effect of these spending cuts will be felt, at least temporarily.

What is Sequestration

In 2011, Congress passed the Budget Control Act (BCA), which imposed caps to reduce discretionary spending by over $1 trillion from 2012-2021. In addition, this act established the Joint Select Committee on Deficit Reduction (the so-called "Super-Committee") to reduce the deficit by an additional $1.2 trillion, but in the case that they were unsuccessful, automatic spending cuts would be applied across the board beginning in January 2013. Although Congress was able to come up with a last-minute deal on taxes last month, they were unable to come up with legislation to replace the sequester.

Understanding Sequestration

The first batch of cuts from the sequester are scheduled to take effect on March 1, 2013. Sequestration will reduce total government spending authority by $85 billion in fiscal year 2013, and will be split evenly between defense and non-defense spending. Although there is still time for Congress to strike a deal, the breakdown of the sequester in fiscal year 2013, as estimated by the Congressional Budget Office (CBO), is shown in Chart 1 on the following page:

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The $85 billion of cuts in spending authority would amount to fiscal drag of about 0.55% of GDP in fiscal year 2013. However, the CBO estimates that discretionary outlays will only drop by $35 billion and mandatory spending will be reduced by $9 billion[2]. This would delay some of the effects of sequestration until the following fiscal year, possibly cutting the effective amount of fiscal drag slated for FY13 in half. Furthermore, equally important as what happens in 2013 is what happens in 2014 and beyond; as shown in Chart 2, while the sequester would help bring down the deficit over the next few years, it does little in the way of addressing the larger issue of entitlement spending, and as a result, the deficit would begin growing again in 2016, even if the sequester were fully implemented.

Chart 1: CBO Estimates of Automatic Spending Reductions
Fiscal year 2013, billions USD

	Reduction in Budgetary Resources	Percentage Reduction
Defense		
Discretionary	$42.7	7.9%
Mandatory	*	7.8%
Total	**$42.7**	**7.9%**
Nondefense		
Discretionary	$28.7	5.3%
Mandatory		
Medicare	$9.9	2.0%
Other	$4.0	5.8%
Total	**$42.7**	**4.6%**
Total	**$85.4**	

* = between zero and $50 million.

Sources: CBO, J.P. Morgan Asset Management. Data are as of 2/15/13.

Chart 2: The Deficit and Sequestration

The Deficit Excluding the Sequester												
Fiscal Year	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**
CBO Baseline Deficit, $bn	-1089	-845	-616	-430	-476	-535	-605	-710	-798	-854	-957	-978
CBO Baseline Deficit, % GDP	-7.0%	-5.3%	-3.7%	-2.4%	-2.5%	-2.7%	-2.9%	-3.2%	-3.5%	-3.6%	-3.8%	-3.8%
Adjustments:												
Sequester (inc. debt service)	0	-42	-90	-101	-108	-116	-124	-129	-136	-142	-138	-141
Revised Nominal GDP	15,549	16,076	16,736	17,733	18,900	20,074	21,067	22,019	22,990	23,984	24,997	26,051
Revised Deficit, $bn	-1089	-887	-705	-530	-584	-650	-729	-839	-934	-996	-1096	-1119
Revised Deficit, % GDP	-7.0%	-5.5%	-4.2%	-3.0%	-3.1%	-3.2%	-3.5%	-3.8%	-4.1%	-4.2%	-4.4%	-4.3%

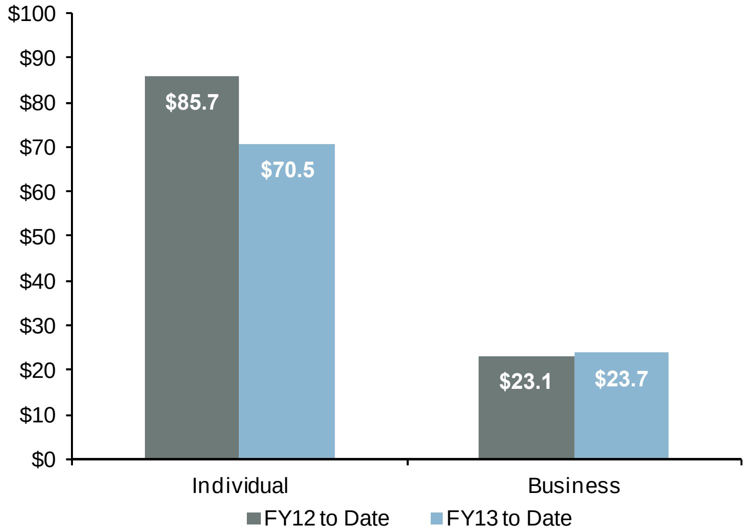
Sources: CBO, J.P. Morgan Asset Management. Data are as of 2/15/13.

What the Sequester Might Mean

Sequestration comes with a number of implications for both the economy and markets. The reduction in government spending will result in significant fiscal drag, creating an additional headwind for already sluggish U.S. growth. The deal struck on New Year's Day provided more than enough austerity for the economy to handle this year, making the imposition of additional drag at the current juncture appear both unnecessary and somewhat dangerous. As is the case with Europe, when economic growth is weak, it is not the right time for austerity; the U.S. needs to change the trajectory of its federal finances, but this issue should be addressed once the pace of growth has accelerated and be focused on curbing entitlement spending in the long-run rather than discretionary spending in the short-run.

There are ways that the impact of sequestration could be lessened. The debate over the continuing resolution funding the government through March 27 could provide lawmakers with the opportunity to moderate the impact of the sequester, either by giving departments and agencies more flexibility in when/how they spend their funds, or by raising the current spending caps. Additionally, as shown in Chart 3, the Treasury has issued $14.6 billion less in tax refunds to individuals and businesses than they had at this point in fiscal year 2012[3], suggesting that late-arriving refunds could help further mitigate the impact of sequestration on growth in the second quarter.

Chart 3: Federal Income Tax Refunds Issued
As of February 13 of the respective year, $bn



Sources: U.S. Treasury, J.P. Morgan Asset Management. Data are as of 2/15/13.

Acceleration in the pace of tax refunds could cause consumption to strengthen, helping to offset some of the decline in government spending. This could be further supported by continued improvement in housing, as rising home prices create a wealth effect that supports consumer spending.

Turning to the markets, the sequester would have a negative impact on confidence and could cause markets to decline. Equities have continued to move higher as March 1 approaches, possibly reflecting the belief that because Congress was able to come to a last-minute deal regarding the fiscal cliff, they will be able to do it again. However, it is also possible that investors do not understand the sequester or are simply choosing to ignore it; either way, this may be a sign of complacency, as sequestration looks set to occur as scheduled. Finally, any further delay of the spending cuts or a resolution that does not bring down the debt and deficit would likely put the U.S. credit rating on the chopping block, as both Moody's and Fitch have warned that the U.S. needs to get its federal finances on a more sustainable trajectory.

Moody's, January 2, 2013: "Thus, further measures that bring about a downward debt trajectory over the medium term are likely to be needed to support the Aaa rating."[4]

Fitch, January 15, 2013: "In the absence of an agreed and credible medium-term deficit reduction plan that would be consistent with sustaining the economic recovery and restoring confidence in the long-run sustainability of U.S. public finances, the current Negative Outlook on the 'AAA' rating is likely to be resolved with a downgrade later this year even if another debt ceiling crisis is averted."[5]

So what would the sequester "feel like"? From what we can tell, sequestration would feel a little bit like a government shutdown, as slowly but surely the effects of lower government spending manifested themselves in our everyday lives. For example, cuts to the USDA's budget could cause them to layoff meat inspectors, resulting in less meat on the shelves of the local grocery store. In addition, cuts to TSA spending could result in longer security lines at the airport, and cuts to housing and urban development could impact the availability and cost of affordable housing. These types of things would continue in areas where the government plays a role, and as the public became increasingly frustrated, Congress would eventually have to go back to the drawing board and come up with a solution. However, a late deal is not the optimal outcome; rather, Democrats and Republicans should recognize the importance of coming together to craft a solution that addresses this issue, as well as the broader one of entitlement spending, before the effects of sequestration are felt.

Endnotes

[1] http://thehill.com/polls/282149-the-hill-poll-few-voters-know-what-sequester-actually-is. February 11, 2013.

[2] The Budget and Economic Outlook: Fiscal Years 2013 to 2023. Congressional Budget Office. February 2013.

[3] Daily Treasury Statement. February 13, 2013.

[4] Moody's Anticipates Further US Fiscal Action Following "Fiscal Cliff" Deal. http://www.moodys.com/research/Moodys-Anticipates-Further-US-Fiscal-Action-Following-Fiscal-Cliff-Deal--PR_263047. January 2, 2013.

[5] Fitch: Debt Ceiling Delay Would Prompt Formal US Rating Review. http://www.fitchratings.com/creditdesk/press_releases/detail.cfm?pr_id=779570&cm_sp=USecon-_-research-_-Debt%20Ceiling%20Delay%20Would%20Prompt%20Formal%20US%20Rating%20Review. January 15, 2013.