SEQUESTRATION: SEPARATING FACT FROM FEAR

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INTRODUCTION

The U.S. federal government's 'sequestration' is a plan to reduce federal spending by $1.2 trillion over the next ten years that was put into effect as part of the Budget Control Act of 2011. Originally developed by President Obama as a means to force negotiation on spending and revenue adjustments during the 2011 debt ceiling debate, it had been scheduled to automatically take effect on the first day of 2013. After its two month postponement, sequestration appears increasingly likely to now take effect on March 1.

LITTLE TO FEAR

Although several politicians and economists have garnered headlines recently by fanning fears that sequestration will drive a fragile U.S. economy into a recession, Laird Norton Wealth Management does not believe this will be the case. In fact, the reductions in spending at the national level are quite slight when viewed in the context of the federal budget or the size of the U.S. economy.

Despite the fact that many politicians continue to refer to $85 billion in reduced spending for fiscal year 2013, the Congressional Budget Office (CBO), the nonpartisan analytical group for Congress, has indicated that sequestration will reduce planned expenditures by $44 billion this year. At roughly 1.2% of the annual federal budget, this should not be painful at the national level. At approximately 0.3% of the U.S. economy, it is hardly enough to trigger a recession. In fact, the $160 billion income tax increases effective this year are more than 3.6 times the size of the spending reductions mandated by sequestration. Should the economy contract in 2013, it is unlikely to be the result of reduced federal spending from sequestration. Of course, some individual families and firms will be greatly impacted by sequestration on a personal level but the national impact should be minimal.

The lion's share of both current and forecasted federal spending resides within the entitlement programs, which will not be impacted by sequestration. Sequestration only impacts discretionary spending. Medicare, Medicaid and Social Security will not

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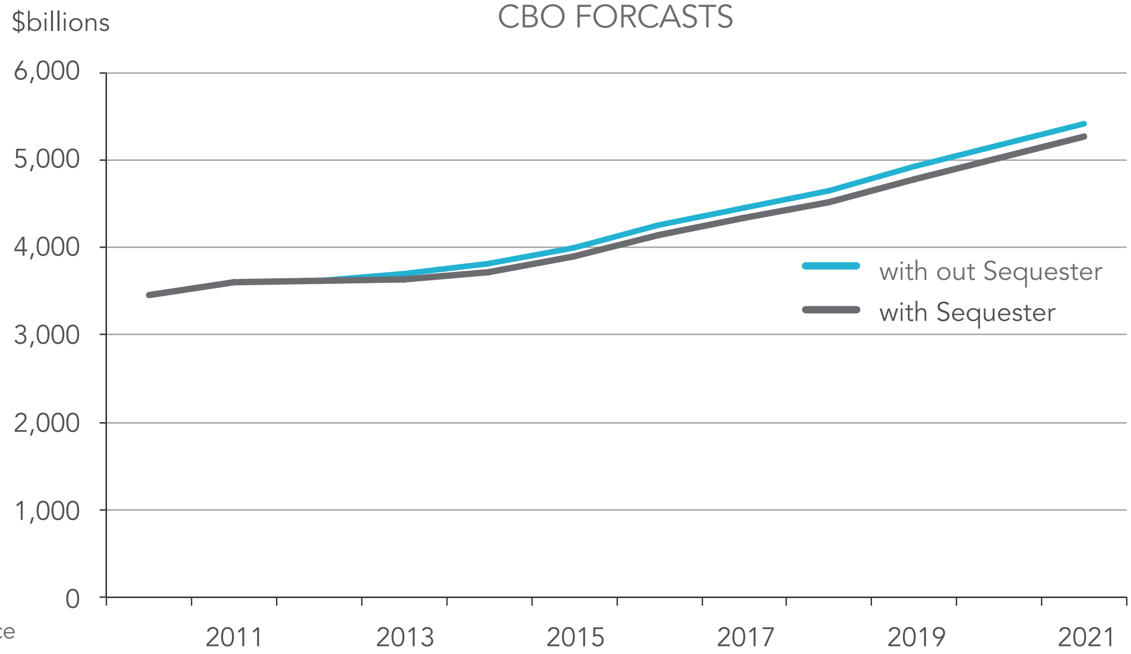
be affected. As these three areas of spending have increased, discretionary spending has been falling as a percentage of federal expenditures and now stands at only 36% of the budget (19% defense, 17% non-defense).

REDUCED INCREASES ≠ CUTS

Additionally, it should be kept foremost in the minds of investors that sequestration is designed to temper the annual increases in federal spending. These spending reductions do not cut spending from 2012 levels. Rather, they reduce the planned increases in federal expenditures. However, the across-the-board implementation approach does mean that some current projects and employees will be impacted. Despite the proposed spending reductions, the CBO still predicts increases in federal spending with or without the reductions brought about by sequestration (as shown in the chart below).

FEDERAL SPENDING
CBO FORCASTS



SOURCE OF DATA:
Congressional Budget Office

A decreased rate of expansion in federal spending need not strike fear in the hearts of investors. Absent the spending reductions, the CBO projects $2.5 trillion in federal

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spending over the next ten years. Sequestration brings this estimate down to $2.4 trillion by reducing non-defense discretionary spending by about 5% and defense spending by approximately 7%. This works out to be a fairly trivial difference when spread out over a decade. Again, these are not spending cuts that one would normally apply to a household or business budget. These are reductions in expected spending increases baked into federal budgets.

Furthermore, these reductions would come on the heels of dramatic increases in federal spending. In the five years from 2008 to 2013, non-defense discretionary spending increased by 16.6% (or 87.5% if the 2009 economic stimulus package is included) according the House Budget Committee. Defense spending rose by 11.6% during this time. Should sequestration become a reality, federal spending is still expected to increase each and every year of the next decade with non-defense discretionary spending increasing by 12% and defense spending growing by 18%, cumulatively.

The increased probability of sequestration taking effect has not led us to revise the likelihood of a U.S. recession in the near-term. The reductions in spending are simply too small as a percentage of the economy to materially impact near-term economic growth. Further, it has not motivated us to alter our investment strategies. In fact, over the long term, reducing the built-in acceleration of federal spending should improve our economic prospects by allowing the private sector access to resources which would otherwise have gone to the government.

ROLE OF POLITICS

While the spending reductions mandated in the sequestration are quite small relative to both the federal budget and the economy, politicians and department leaders will ultimately determine how the reductions are enacted. The risk here is that decisions made by our elected officials may actually affect the economy more than necessary.

Recent press conferences focused on instigating fears that sequestration will result in a partial government shutdown. A shutdown could reduce the government's ability to respond to catastrophes or even to keep our society humming along

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smoothly. The Transportation Secretary, for example, recently declared that sequestration will force the Department of Transportation to close down air traffic control towers at many commercial airports and to reduce air traffic at major transportation centers. Such decisions would cause huge disruptions to businesses and the lives of many citizens.

The rationale for this claim is that the nearly 47,000 employees of the Federal Aviation Administration (FAA) will need to be furloughed for one or even two days this fiscal year. But after a dramatic surge in spending, could it really be the case that government programs have no budgetary fat to trim? Certainly furloughs of air traffic controllers would reduce the FAA's employee compensation costs, which are currently slated to run about $600 million this year. However, the FAA also budgets more than 80% of their employee costs, more than $500 million annually, for consultant fees. Reducing the use of consultants could bring spending in line without threatening essential services. Given the rapid expansion of government spending over the last five years, it is difficult to conceive that reducing planned increases in spending by 5%-7% is not possible without sending the economy – or the nation – into a tailspin.

SUMMARY

Should it go into effect as we predict, sequestration will determine the programs in which spending increases will need to be reduced along with the magnitude of these reductions. Even with sequestration, however, it seems very unlikely that the U.S. will face reductions in its readiness to protect its citizens or to conduct its affairs unless our elected officials choose to make it so. Indeed, federal spending is still expected to grow each year that sequestration will be in effect as it is designed to reduce the pace of spending increases rather than to reduce actual spending levels.

Although the spending reductions for 2013 and the next decade may seem large when viewed in isolation, they are quite manageable when compared to the size of either the federal budget or the economy. Should sequestration proceed, we believe the short-term impact on the health of the U.S. economy will be very slight, with the impact on GDP during fiscal year 2013 being perhaps a quarter of one percentage point. We expect the long-term impact to be positive, as sequestration would mark

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at least a first step toward reducing the federal debt burden and would ultimately allow the private sector a greater share of economic growth.

While we believe that sequestration will take effect on March 1, we do not believe it warrants changes in our investment strategies. We will continue to monitor the economic and political situations outlined above very closely for both risks and opportunities, but see no need for changes to your portfolios at this time.

ABOUT THE AUTHOR

Robert Benson is chief investment officer at Laird Norton Wealth Management. He is responsible for setting and implementing investment strategy at the firm, as well as selecting managers for our client portfolios. Bob has more than 20 years of experience in the financial industry, most recently at Russell Investments, primarily in investment strategy, asset allocation and risk management. He received his CFA designation in 1997, and he's a member of the CFA Institute as well as the CFA Society of Seattle. He has an MBA from Northwestern University. Bob has served on the boards of both start-up firms and non-profit organizations.

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