

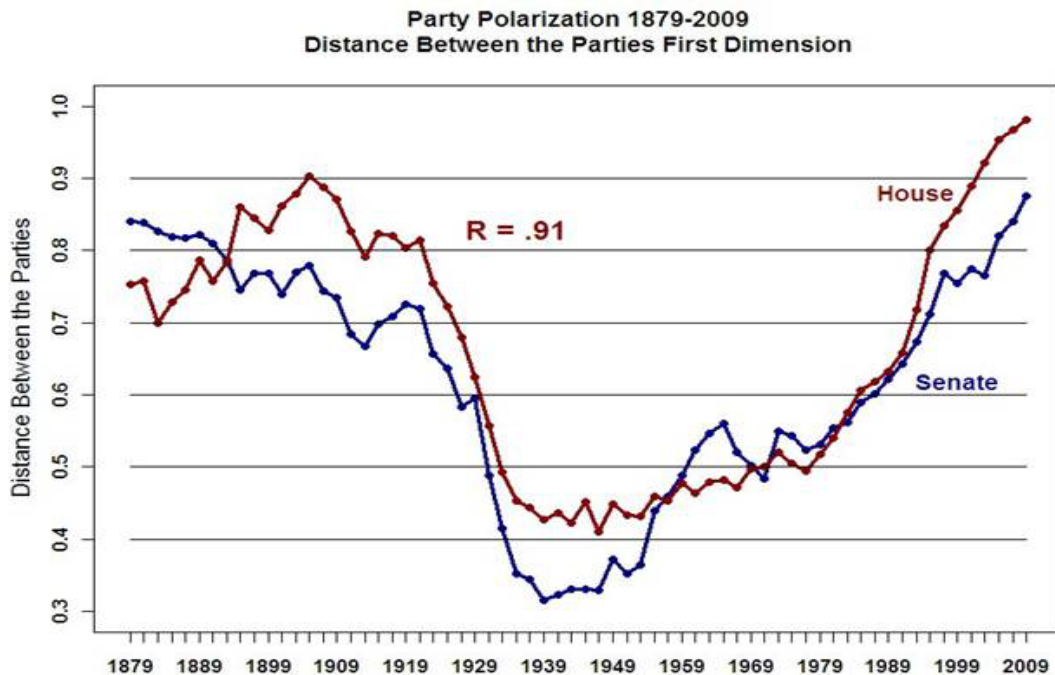
February 3, 2010

**Political polarization is deepening faster than markets think: Market volatility is underpriced.**

- ✓ Obama and Congress' half steps on the budget, the deficit commission, and Bernanke's confirmation show the effects of deepening fiscal deterioration and paralysis.
- ✓ Fiscal deterioration intensifies party polarization. Polarization is now at a 150 year high.
- ✓ Markets are under-pricing risks of budget gridlock and an aggressive budget struggle.

Economists talk about the current downturn in terms of the 1930s. Politically the two periods are very different, and the difference will likely make the economics very different too. Inter-party struggle has risen above the highs of the last 150 years. The chart below from *Polarized America* by McCarty, Poole and Rosenthal provides a historical view. (Special thanks to ISI's Tom Gallagher for making us aware of this work.) Polarization began to rise quickly in the early 1980s when worries about the Social Security System surfaced, and President Reagan appointed Greenspan to head a Social Security Commission.

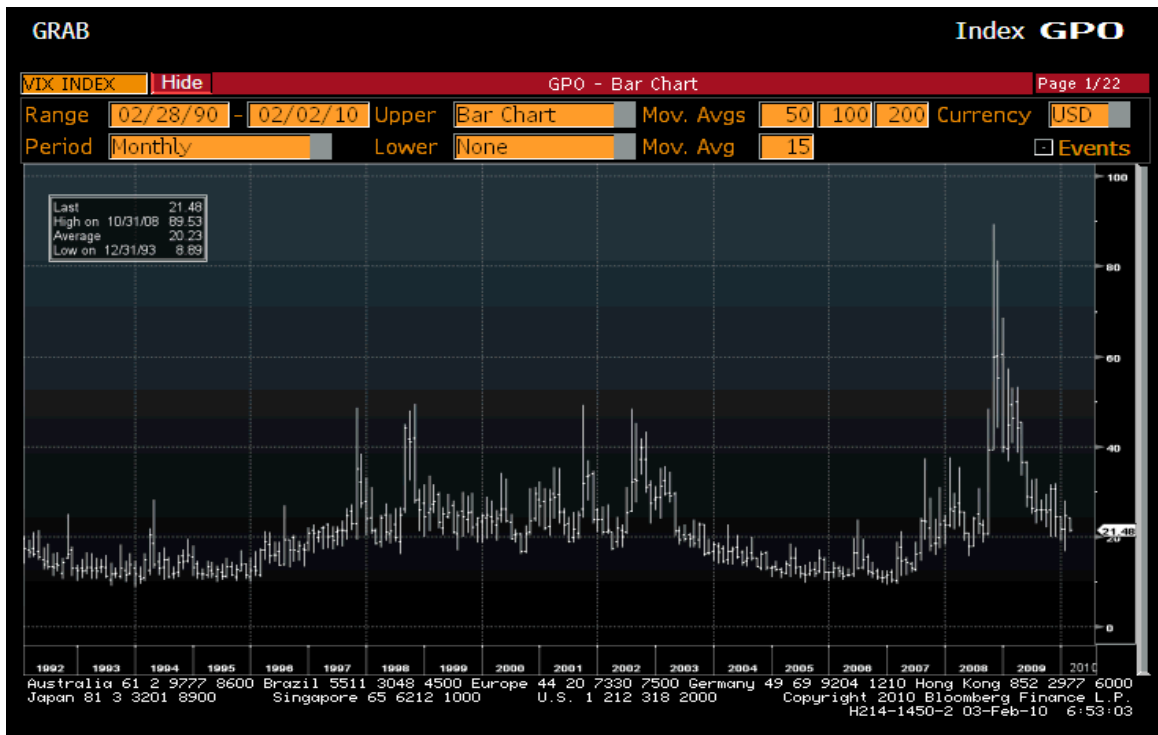
Polarization is a breakdown of collaborative behavior when extreme factions of political parties gain dominance and moderate voices lose power and influence. Polarization is paralyzing Congress and the Obama administration. Health care reform has been postponed. Congress rejected tough deficit commission legislation, and the administration chose not to support a debt limit glide-path (we got that wrong). The best Obama could do was propose limits on certain spending and tax loopholes in his budget, and announce he would create a deficit-reduction commission. In our view, fiscal deterioration aggravates political polarization, and because fiscal conditions are going to get much worse, polarization will get worse. We think markets are underestimating the speed and severity of the coming budget fight.



Markets are beginning to show concern, like a man waking up in a hospital realizing he's been in a car accident,

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but true realization hasn't occurred. As evident in this chart of stock market volatility since 1992, risk perceptions are as high as they were in the turbulent 1990s, but nowhere near their highs.



The spread between 10 and 2-year Treasury rates is more realistic about fiscal gridlock risks and real interest rates. It's at a two decade high and threatening to go higher.



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### **Fiscal policy intensifies political polarization**

To understand polarization, we need to think like people running for re-election. To keep their jobs they need to protect what their supporters already have and maybe get a little more. As the budget tightens, it's much harder to increase spending in ways that help their voters without borrowing or raising taxes. The few areas that get increases are justified by some special urgency, and the costs of which can be put off a decade or more. Military expansion, homeland security, tax cuts, and entitlement promises meet these tests.

Military spending is specifically organized to provide jobs in every Congressional district. Because the Iraq War and now the Afghan War were presented as emergencies and paid for by borrowing, military spending was increased without an increase in revenues or cuts in other spending. The 9/11 tragedy and the early 2000s' recession led to further major tax cuts whose costs could be explained away by supply-side economic logic or ignored because they appeared temporary. Rising pharmaceutical costs made expanding Medicare to include prescription drugs an urgent voter issue. Because the budget hits would not occur until decades in the future, Congress created a new drug entitlement promise in 2003. Interestingly, the present value cost of that promise was equal to Social Security's, and was enacted at the same time President Bush was going around the country trying to get Americans to support Social Security reform. How large were the present value costs? \$11 trillion, each.

This wasn't the first time US government promised what it couldn't – or more importantly wouldn't -- pay for. One of the most interesting moments in US fiscal history was President Roosevelt's 1935 comment about Social Security after looking at 50-year population projections, "...but this is the same old dole under another name. It is almost dishonest to build up an accumulated deficit for the Congress...to meet in 1980. We can't do that. We can't see the United States short in 1980 any more than in 1935." (Francis Perkins, *The Roosevelt I Knew*, 1945).

### **Revenue exhaustion is here. Conflict is unavoidable.**

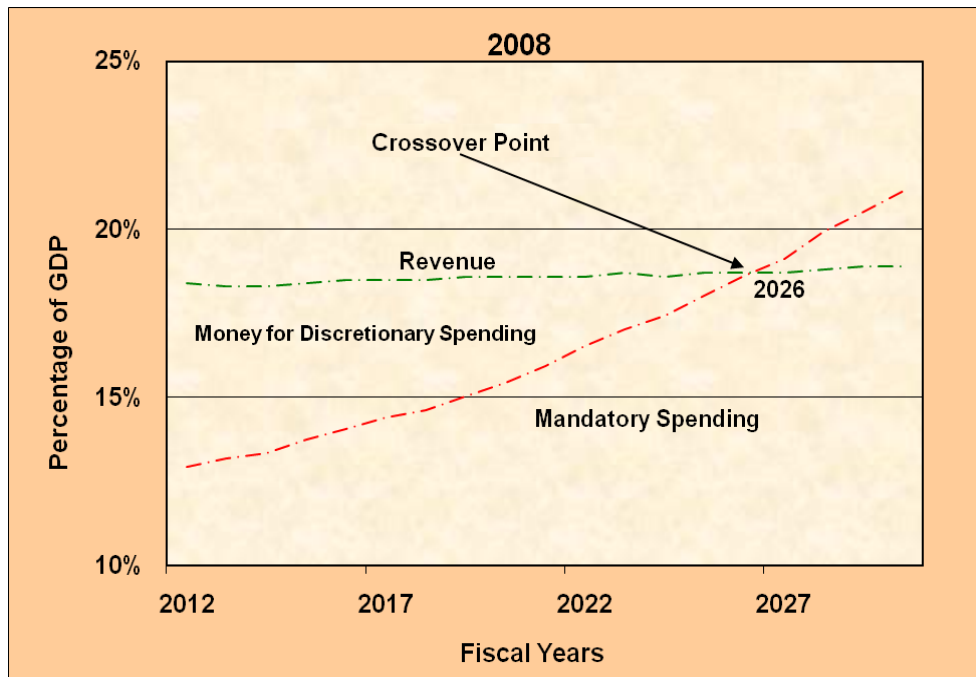
In the charts below, note how quickly the revenue and mandatory spending lines converge and squeeze "Discretionary Spending". Discretionary spending is annual appropriations for government activities such as air traffic control, federal courts and prisons, the CIA and FBI, homeland security, national defense, foreign aid, parks, highways, etc. – and earmarks, the increasingly vital lubricant of political deal-making. "Mandatory Spending" includes Social Security, Medicare, and other statutory entitlements, and interest on federal debt, which also must be paid to avoid default. "Revenue" is total federal revenues. All are expressed as a percent of GDP. The triangle formed by "Revenue" and "Mandatory Spending" is what's left for "Discretionary Spending" – before having to resort to unsustainable borrowing.

Every Member of Congress has seen hundreds of budget charts and graphs of debt building up in the future. They feel fiscal tightening in hundreds of meetings with constituents and in legislative votes. For them, the rate of budget tightening is what matters most. Because the rate of budget tightening has been accelerating year by year, it should not be surprising that political polarization is soaring.

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In 2008 Members of Congress knew mandatory spending would use all revenues in about 18 years. That is, absent large tax increases or spending cuts, or rising deficits, and assuming prevailing law and favorable economic trends, no revenues would be available for discretionary spending after 18 years. The mandatory expense line would cross the revenue line in 2026, unless taxes were raised, spending promises were cut, or government borrowing increased exponentially.

**Fiscal Outlook in 2008:  
Mandatory Spending Exceeds All Federal Revenue by 2026  
Absent Very Large Spending Cuts or Increases in Taxes or Deficits**



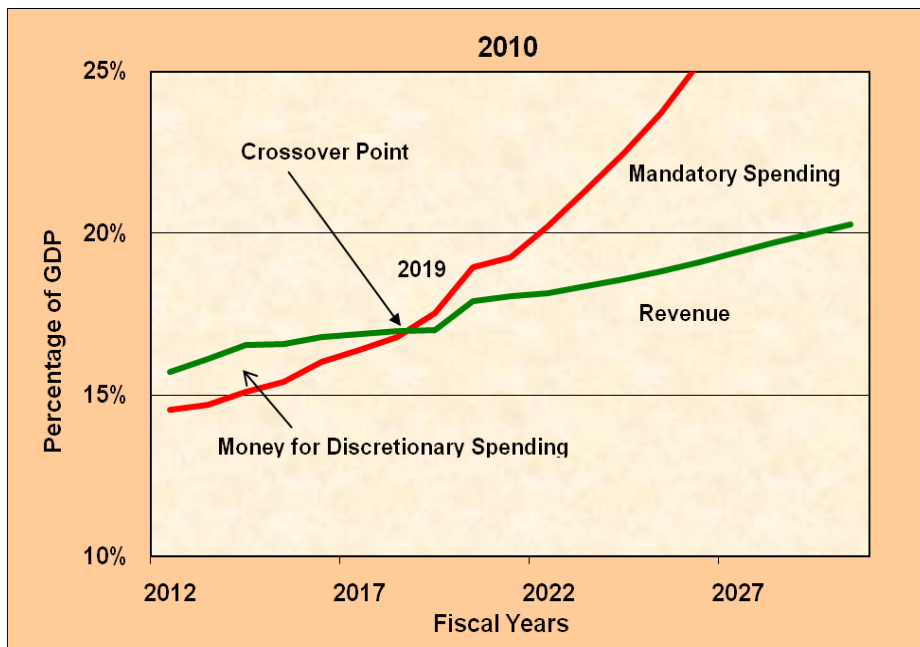
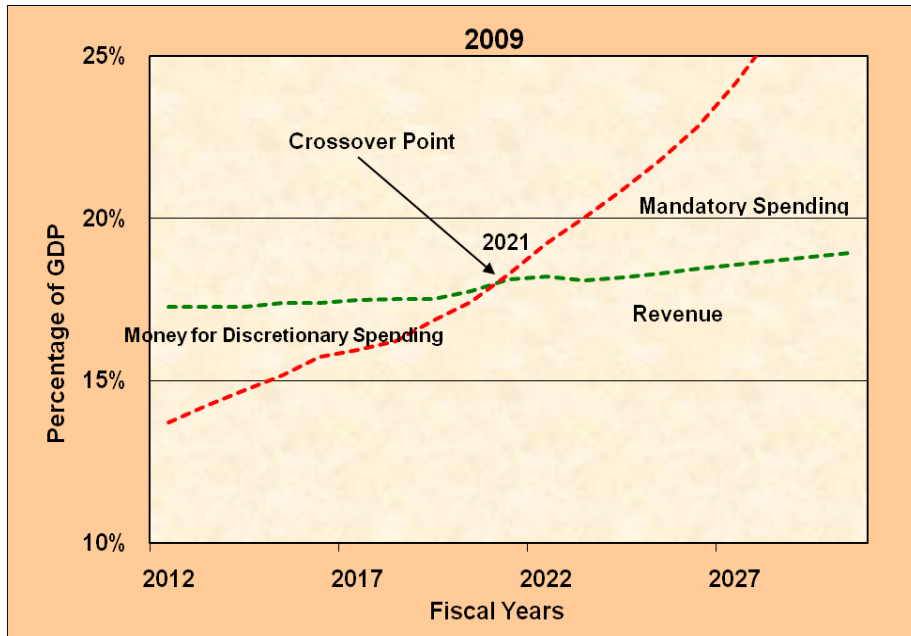
Straight lining it, revenue available for “discretionary spending” was declining almost half a percent a month -- 5.5% per year, 33% every six years, zeroing out in 18 years. To get a sense of it, imagine Americans locked in a room with the air turned off and told in 18 hours there will be no oxygen left, unless they do some very, very extreme things. As people sense the problem, they begin to jostle for air. As hours go by, things get grim. Republicans and Democrats knew the budget oxygen was disappearing and were beginning to jostle.

Then things got much worse. As the charts below show, the crossover year moved nearer, from 2026, to 2021, and then to 2019 where it is today. Borrowings increased interest expenses, which drove up mandatory spending at the same time the recession pushed revenues down. Money for discretionary spending shrank alarmingly. Fiscal pressures on elected officials worsened and polarization intensified.

Is a serious budget struggle avoidable? Our answer is, no. To eliminate the need for grim choices the US needs about 8% annual nominal GDP growth. At this level, deficits are sustainable at around 3% and federal debt to GDP ratios can be kept at about 60%. What is the US’s long-term historic nominal growth average? About half that. Each percentage point of growth is equal to about \$140 billion of hard choices per year. That’s why budget warfare, including political gridlock and possible shutdowns, are as certain as you reading this page.

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**Fiscal Outlook in 2009 and 2010:  
Mandatory Spending Exceeds All Federal Revenue at Steadily Earlier Points  
Absent Very Large Spending Cuts or Increases in Taxes or Deficits**



In upcoming reports, we will layout fiscal crisis milestones and discuss polarization and its effects on Fed independence and monetization.

Rob Dugger and Benhan Limketkai

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