THE FISCAL CLIFF—IS IT WHEN, NOT IF?

SUMMARY
Equity markets have been buffeted in recent months by slowing global growth and renewed worries over the European debt crisis. On top of these concerns, the United States faces a unique challenge as nearly $700 billion in increased taxes and cuts in governmental spending (the “fiscal cliff”) are scheduled to come into effect during the lame duck session this year-end. While passing significant legislation in a lame duck session can be difficult, the current political divide in Washington makes this particularly unfortunate timing. In our opinion neither the Republicans nor Democrats are likely to conclude that shutting down the government, or slamming the brakes on the economy, are good politics. While the unpredictable outcome of the November U.S. Presidential election will play a role in tactics, our best assessment is that the politicians will extend a majority of the “fiscal cliff” provisions for up to six months to give them time to negotiate a solution. The U.S. is also projected to hit its debt limit around year-end, with the Treasury Department able to buy an additional two months or so of time by disinvesting certain Treasury securities holdings. Financial markets are more concerned about long-term budgetary control than short-term deficits, and we expect the financial markets to give Washington time to address this. The history of countries experiencing debt overhang periods supports this possibility, as lower growth leads to less demand for credit and keeps real interest rates at levels lower than many might expect.

EXHIBIT 1: GOVERNMENTAL ARREST

Exhibit 1 shows the performance of the S&P 500 Index and the 10-year U.S. Treasury bond during two recent fiscal crises in the United States: the 1995-96 partial government shutdown and the 2011 debt-ceiling debate. The former event threatened to suspend essential government operations while the latter threatened to put the country’s sovereign debt into default. In both instances, 10-year Treasuries rallied...
early on as investors continued to view the U.S. as a safe haven (even in the face of potential default). Interestingly, while 10-year rates “normalized” after the ’95-’96 government shutdown was resolved, 10-year rates stayed depressed in the aftermath of the 2011 debt ceiling debate and have recently reached all-time lows due to growth concerns and safe-haven flows. Regarding the stock market, it was a “tale of two cities.” The S&P 500 pressed on through the ’95-’96 government shutdown but fell by more than 20% in the lead-up to the debt ceiling deadline (although was able to recover nearly all of its losses over the next six months). These two contrasting experiences clearly illustrate the substantial impact governmental action – or inaction – can have on the markets.

Before analyzing the potential ramifications of the upcoming “fiscal cliff,” let’s first outline what exactly is at stake. Exhibit 2 itemizes the provisions – both tax cuts set to expire and reductions in spending set to be enacted. To illustrate the scale of these provisions, we are showing them as percentages of the 2011 deficit, budget and gross domestic product (GDP). In sum, the $670 billion in potential fiscal contraction represents over half of the 2011 deficit and 4.4% of nominal GDP. According to the Congressional Budget Office, the tax and spending policies that will be in effect under current law would reduce the federal budget deficit by 5.1% of GDP in 2013. The biggest component of the fiscal cliff is the expiration of the Bush-era middle and upper-income tax cuts, which combined would result in a nearly $200 billion “fiscal shock” (1.3% of GDP). If all tax increases took place, there would be an approximate $450 billion hit (3% of GDP) – although it is likely that the Alternative Minimum Tax exemption level would be raised (as has been done in the past few years) meaning the real fiscal shock from tax increases would be closer to 2% of GDP. Besides taxes, the two main fiscal drags are the planned reduction in discretionary spending (mostly related to the wind-down of Iraq and Afghanistan wars) representing 0.5% of GDP and the sequester cuts (tied to the debt ceiling increase) representing 0.6% of GDP.

<table>
<thead>
<tr>
<th>Provision</th>
<th>Impact ($B)</th>
<th>% of 2011 Deficit</th>
<th>% of 2011 Budget</th>
<th>% of 2011 GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bush tax cuts for middle income</td>
<td>150</td>
<td>11.6</td>
<td>4.2</td>
<td>1.0</td>
</tr>
<tr>
<td>Payroll tax cut</td>
<td>116</td>
<td>9.0</td>
<td>3.2</td>
<td>0.8</td>
</tr>
<tr>
<td>Alternative Minimum Tax</td>
<td>94</td>
<td>7.3</td>
<td>2.6</td>
<td>0.6</td>
</tr>
<tr>
<td>Sequester</td>
<td>85</td>
<td>6.6</td>
<td>2.4</td>
<td>0.6</td>
</tr>
<tr>
<td>Discretionary spending</td>
<td>84</td>
<td>6.5</td>
<td>2.3</td>
<td>0.5</td>
</tr>
<tr>
<td>Bush tax cuts for upper income</td>
<td>45</td>
<td>3.5</td>
<td>1.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Tax extenders</td>
<td>30</td>
<td>2.3</td>
<td>0.8</td>
<td>0.2</td>
</tr>
<tr>
<td>Extended unemployment insurance benefits</td>
<td>25</td>
<td>1.9</td>
<td>0.7</td>
<td>0.2</td>
</tr>
<tr>
<td>Health care law taxes</td>
<td>21</td>
<td>1.6</td>
<td>0.6</td>
<td>0.1</td>
</tr>
<tr>
<td>Physician payment cut</td>
<td>20</td>
<td>1.5</td>
<td>0.6</td>
<td>0.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>670</strong></td>
<td><strong>51.7</strong></td>
<td><strong>18.6</strong></td>
<td><strong>4.4</strong></td>
</tr>
</tbody>
</table>

Source: ISI Group, Northern Trust Global Investments, Congressional Budget Office.
As noted above, the “worst case scenario” amounts to a 4.4% fiscal drag. However, we need to contemplate whether the demand destruction caused by cuts in federal spending can be offset by households and corporations (dampening the impact) or, alternatively, cause the private sector to demand even less (exacerbating the impact). For instance, would a 1% cut in government spending directly translate into a 1% fall in gross domestic product? Would the fall be greater due to the negative impacts on consumer confidence? Or would the fall be dampened as money no longer being spent by the government could now be spent by the public sector – and allocated in more efficient ways? The question of how changes in government spending may impact the broader economy – the fiscal multiplier – has been the source of much ongoing debate in economic circles. Estimates on the normal multiplier on government spending range between 1.5 and 2.0, while estimates on the multiplier on tax cuts range between 0.5 and 1.0. However, these multipliers were based on the normal flow of credit in a steady-state economy, whereas today’s constrained credit environment likely reduces the multipliers. Christina Romer, former chair of the Council of Economic Advisors, posits that the impact of a spending increase in this environment may actually be greater as the recipients of the additional income are more likely to spend it.

However, the problem with these academic studies on the fiscal multiplier is that they tend to focus on the positive impacts from stimulus spending – not the negative impacts from fiscal tightening. Also, fiscal policies are generally a reaction to the state of the economy. For instance, taxes are decreased or public works projects are initiated during economic downturns; making it necessary to sort out the impacts due to the weak economy from the impacts of the fiscal policy. A recent study by Christina and David Romer addressed both of these issues. They looked at all post-war tax policy actions and characterized them as either “endogenous” – tax policy related to the state of the economy – or “exogenous” – tax policy undertaken for less countercyclical reasons (such as reducing government debt). Exogenous tax changes would include President Reagan’s tax cuts in the early 1980s to bolster long-term growth prospects, or President Clinton’s tax increases in 1993 to address the deficit. When only looking at these exogenous tax increases, the drag on GDP shows a lagged but notable impact – topping out at an estimated 3% hit to GDP 2½ years out.
A discussion of the political path to addressing the fiscal cliff must turn to the upcoming elections. The predicted outcomes of November’s U.S. national elections are shown in Exhibit 4. According to Intrade, Republicans have a 77% chance of retaining a majority in the House and a 55% chance of gaining control of the Senate. Bettors expect a 53% chance of an Obama re-election – with continuing weak job growth and volatile stock markets weighing heavily on his election campaign. Also, the resounding win by Wisconsin Governor Walker yesterday in his recall election may bolster Republican chances in the Congressional and Presidential elections. The elections are a long-time off in political terms, but if the outcome follows current polls, the U.S. may continue to have a divided government at least through 2014. This could complicate the ability of the Congress and the White House to reach agreement between the national elections on November 6, 2012 and when the new office holders start work (January 3, 2013 for Congress and January 20, 2013 for the President).
The expiration of the Bush-era tax cuts would seemingly be a considerable catalyst for policy compromise, as could the substantial cuts to defense and discretionary spending mandated for in the sequestration. However, the policy differences between the Republicans and Democrats are vast as demonstrated by a review of tax policy. While there is relatively broad support within Congress for extending the middle-income tax cuts, the Democrats have little appetite for extending the upper-income tax cuts. Philosophically, many Republicans are opposed to delinking the two issues. This is the type of issue that will be the subject of heavy negotiation, a process that will likely take many months (at a minimum). This argues for an extension of current policies during the lame duck session to avoid market disruption and allow for negotiation with the new office holders. However, if the Republicans gain control of either the Senate or White House, that would seem to reduce the odds for a lame duck session deal as they may believe they can strike a better deal once in office – although, in such a scenario, the markets may look through the lack of a tax break extension to the probability that the new Republican-majority would put tax reform at the top of their agenda.

So what would be the effect of the fiscal cliff? What would a dramatic slowing in U.S. growth mean for U.S. companies and the stock market? Exhibit 5 charts the year-over-year growth of S&P 500 revenues alongside year-over-year growth in U.S. and global GDP. Our analysis shows that S&P 500 revenues correlate more closely to global growth rates than U.S. growth rates. From 1994 to 2011 the correlation between revenue growth and global growth was 0.7, versus a 0.5 correlation between revenue growth and U.S. growth. This is primarily the result of companies relying more on international markets to grow revenues. This shift is reflected in the geographic composition of S&P 500 sales; in 1998 companies derived 25% of sales internationally, while 33% of sales were sourced from outside the U.S in 2011. This is why we base our revenue expectations for the S&P 500 on global growth, instead of U.S. growth alone. Due to the stronger growth of emerging markets, global nominal GDP growth has handily out-paced U.S. growth for most of the last decade. The current environment is less friendly, as Europe is likely in recession and the major emerging market countries (including China, Brazil and India) are slowing. U.S. companies, and the U.S. stock market, will not be cushioned by global growth in the event of a sharp reduction in U.S. economic growth. In addition, increased investor risk aversion would likely pressure valuations and lead to a sell-off in equity markets.
At the root of the fiscal cliff debate is the longer-term concern about the build-up of debt in developed countries in the wake of the financial crisis. The countries in Exhibit 6 experienced an explosion in central government debt as a percentage of GDP – from 2007 to 2011 the average debt-to-GDP ratio increased from 49% to 81%. Greece and Ireland suffered the largest increases with levels rising from 105% to 161% and 11% to 96%, respectively, while Australia and Canada remain the most fiscally sound with ratios below 35%. In the U.S., the debt to GDP ratio grew from 48% to 80% and is expected to reach 112% percent by 2015 based on IMF estimates. The Congressional Budget Office has recently projected a worsening of the U.S. budget outlook, saying that without changes to current benefits plans or increases in taxes, the federal debt held by the public will reach 199% of GDP in 25 years. While this scenario is unlikely to unfold, as some fiscal restraint is expected, it highlights the scale of the problem that developed countries face globally.

In work by Reinhart, Reinhart and Rogoff (Debt Overhangs: Past and Present, April 15, 2012), episodes of major public debt overhangs in advanced economies over the last 200 years have been characterized by slowed growth and a long duration. Of the 26 episodes they identified, 20 lasted more than a decade and growth was over one percent lower than in other periods. Contrary to conventional wisdom, however, they found less of a penalty from the bond market than expected. In 11 of the 26 debt overhang episodes, real interest rates were either lower or comparable to the lower debt/GDP years. Therefore, the bond market may not be the “vigilante” forcing rates higher as the catalyst for improved fiscal policy in more stable, highly indebted countries like the United States. That has certainly been the experience in Japan over the last two decades.
The scope of the challenge faced by developed economies is highlighted in Exhibit 7, which shows the worsening demographic outlook across major developed economic blocs. For instance, the ratio of working-age population to retired-age population in the U.S. is expected to fall from the current 5 to 1 level to approximately 3 to 1 by 2040. Europe’s problem is even worse with an expected worker/retiree ratio of 2.3 while Japan has already fallen off the demographic cliff. While these numbers are worrisome, it is important to not double count the effects of aging. Our prior discussion about the growing entitlement liabilities in the U.S., and the expected jump in public debt, is tied much more to these demographic changes than the current cyclical downturn. These demographic trends are well-known by policy makers, economists and the financial markets. Exhibit 7 is just a graphic illustration of the severity of the long-term challenge.
Historically, excess debt levels have been addressed through one of four paths: belt-tightening (reducing expenses and raising taxes); inflation; growth or default. Of these options, research shows that belt-tightening and inflation tend to be the paths most traveled, while growth and default tend to happen less often. However, as Reinhart and Sbrancia show in their analysis of government debt liquidation, more subtle forms of debt restructuring often take place, which they refer to as “financial repression.” One form of financial repression is, in fact, inflation and the incidence of such tactics is illustrated in Exhibit 8. Here, median levels of inflation are shown for various countries over both the entire set of data and over periods of debt reduction. The general trend is for inflation to be higher during debt reduction periods. Notable instances are the median level of inflation during debt reduction episodes in Germany (due to the hyper-inflation under the Weimar Republic in the 1920s) and Brazil (due to the inflation problems experienced there in the 1990s). While we do not believe that global inflation will be the path for the developed countries’ debt management challenge, it is a scenario we are increasingly discussing. The U.S. Federal Reserve has discussed the potential of higher inflation, and Germany has discussed allowing increased wage inflation as a way to help rebalance the European economy. These could be early steps in the direction of what we would call “sneaky and sticky” inflation – a long, slow increase in inflation that would meet the definition of financial repression.

**EXHIBIT 8: INFLATE YOUR WAY OUT?**


Note: The vertical axis has been truncated at 15%; therefore, the median inflation levels in debt reduction episodes for Germany, Italy and Brazil (1,764%, 44% and 980% respectively) are not fully captured in the representative bars.

**CONCLUSION**

The fiscal cliff the U.S. is facing at the end of this year represents both a short-term and long-term challenge. Short-term, we believe the severity of the economic impact makes some extension of the current law the most likely outcome – allowing the new
office holders time to legislate a solution in the first half of 2013. Financial market volatility could be elevated through this period due to the unpredictability of the political process. However, political unity could also generate an upside surprise for markets. Whether it is through a one-party sweep that allows an expedited legislative process, or through a “grand bargain” between parties, substantial progress on the long-term deficit would address one of the stock market’s biggest worries.

Longer-term, the scope of the debt overhang is a global issue amongst most developed countries. The better fiscal position of developing countries, along with generally better demographic positions, supports their relatively stronger growth outlook. It also supports the growth outlook for those companies in the developed economies who are benefitting from developing economy demand. Among the major developed economies, we think the short- and long-term outlook for the U.S. is superior to both Europe and Japan due to better productivity and demographics. As these economies wrestle with their growing debt burdens, we will continue to assess the risk that inflation becomes a meaningful part of the debt management process. In this event, real assets such as inflation protected securities, real estate, infrastructure and commodities, will be best positioned to help investors preserve purchasing power. The performance of equities will likely be determined by the trajectory of inflation – a sudden burst will be harmful while sneaky and sticky inflation may lead to increased pricing power and rising nominal profits. In this environment, we believe investment grade bonds will see their primary utility become liquidity management as they lose purchasing power in a rising inflation environment. We are already witnessing this phenomenon today with real interest rates negative across most major sovereign investment grade bond markets.

Special thanks go to Natalie Sproull for data research.

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