Washington Watch

Sequestration budget cuts kick in

The mandatory, across-the-board spending cuts to the federal budget, known as "sequestration," went into effect as the White House and congressional leaders failed to reach a last-minute compromise to avoid it. The current federal budget will be reduced by an estimated $80 billion by September 30, with half of the cuts coming from the military and the other half from discretionary, non-defense items, though the cuts will be phased in over time.

While the dollar amount is large, it is only a small percentage—about 2.3%— of the approximate $3.5 trillion annual federal budget. The sequester cuts are unlikely to derail or significantly impact the U.S. economy, though the reduced spending could create a drag on gross domestic product (GDP) growth this year, according to **Timothy Hopper, managing director and chief economist at TIAA-CREF, who recently discussed the budget sequester.**

What happens now that Congress failed to reach agreement on the sequester on time?

The sequester takes effect and we will experience around $80 billion in reduced government spending from now through the end of fiscal 2013, which is September 30. These cuts will be phased in over time, and while the impact will be felt in many places, the net effect on the overall economy will be small. The budget cuts will slow things down, but will not dramatically alter the course that we're on. Our current forecast calls for around 2% growth in gross domestic product in 2013, which is down from the 2.5% range as a result of the sequester taking effect.

What happens after the sequestration?

The March 1 deadline has been referred to as a "soft cliff," which means that Congress and the White House can still undo the sequester. While broad cuts were triggered on March 1, they are gradual in their implementation. For example, furlough notices for some federal employees will begin to be sent out; yet federal rules require a 30-day notice prior to implementation. The more critical date looming on the horizon for Congress is March 27, which is when the federal government's current funding arrangement, a temporary measure, expires.

The federal government has not passed a budget since April 2009 for the fiscal year 2010 and has been operating on a series of temporary resolutions, in essence continuing to spend at the current levels on rolling six month cycles. It is expected that the House of Representatives will introduce a new resolution in early March to fund the government for the remainder of the current fiscal year. It

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is through this vehicle that the across-the-board nature of the sequester could be replaced with a more thoughtful plan for long term spending cuts.

What is the potential market impact from letting the sequester pass?

We think the sequester is generally priced into markets—there's very little chance for a surprise effect for investors. We may experience increased volatility, but we don't think it's going to turn the direction of markets.

As an investor, how does this affect me?

We do not believe investors should change their behavior because of the sequester, or in reaction to any other single headline or event that we've seen recently.

Through our experience over many market cycles and economic environments, we've taken a disciplined, long-term approach to managing investments, which we believe best matches the needs of our investors. Markets encounter periods of volatility and will often overreact or underreact to headlines and current events, but over the long term, we believe they reflect fundamentals and will revert to their long-term averages. Investors should maintain an approach that is consistent with their risk tolerance and investment objectives and stay invested according to these principles. Trying to time the daily ups and downs of markets is inconsistent with a winning long-term investment strategy.

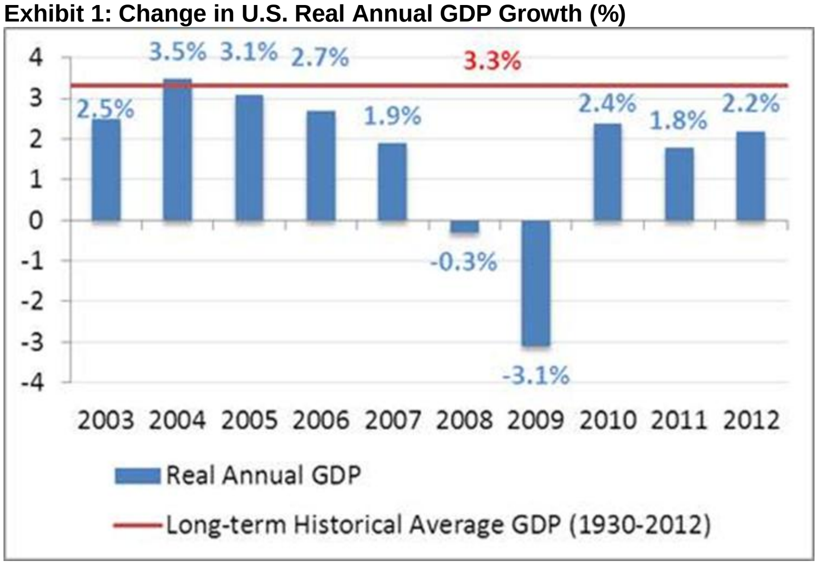
Isn't the economy weakening, as the GDP barely grew during the fourth quarter of 2012?

The Commerce Department reported this week that the U.S. economy grew at an annualized rate of 0.1% in the fourth quarter of 2012, a slight upward revision from the negative 0.1% growth reported in the government's initial estimate but still a very weak reading. During the fourth quarter, private businesses paused to weigh the potential outcomes of the fiscal cliff debate, while government entities reduced spending, and other one-time negative factors such as super storm Sandy hurt GDP growth. Overall, 2012 was a positive year for economic growth, with GDP expanding at a real (inflation-adjusted) annual rate of 2.2% (see exhibit 1). Other economic indicators were strong during the quarter. January's fiscal cliff deal, while not comprehensive, settled critical tax issues, which, for now, removed the worst case scenario off the table, providing some clarity for businesses, investors and consumers. This is reflected in the many positive signs we see in the economy after several years of lackluster growth: a recovery in housing, steady job creation, and strengthening retail and auto sales. Auto sales, which increased 13% in 2012, are one sign of a resurgent consumer, and have continued at a strong pace in 2013. Negative factors in the economy are diminishing, and consumers and businesses are fundamentally healthier. While the sequester certainly removes money from the economy, it should not by itself cause GDP to contract in 2013.

Do you expect economic momentum to continue, even now?

Yes. The average growth rate for 2012 as currently measured was 2.2%. We're expecting growth around 2% this year, though we do expect the pace of growth to accelerate in the second half of 2013, which should carry forward to make 2014 an even stronger year, maybe with growth as high as 3%.

Exhibit 1: Change in U.S. Real Annual GDP Growth (%)



Source: Bureau of Economic Analysis, February 2013

What about the debt ceiling?

The debt ceiling is a different issue. If Congress fails to raise the debt ceiling, then the government will no longer be able to borrow and as a result service its existing debt. While this would have a potentially tremendous negative effect on the economy, it is not our baseline forecast. Congress has agreed to multiple debt ceiling increases in the past, and the expectation is that it will do so again. Unlike the current sequester debate, there is an incentive for both parties to raise the debt ceiling.