RBC Global Asset Management

ECONOMIC COMPASS

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HIGHLIGHTS

- U.S. markets will be challenged by an election, fiscal cliff and debt ceiling over the next six months.
- In an era of public discontent and political division, it is unwise to express absolute confidence regarding their tidy resolution.
- Nonetheless, by far the most likely scenario is one in which each is constructively resolved, avoiding unnecessary market turmoil or enduring losses.
- In fact, our analysis hints that risk assets might even strengthen.

AMERICAN POLITICS, POLICY AND DEBT

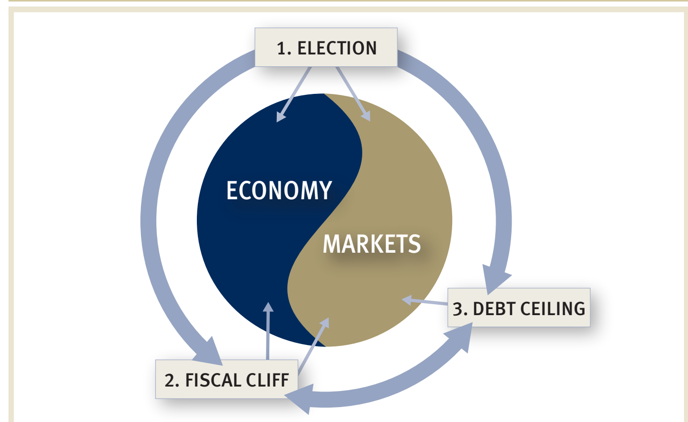
American politics, public policy and government debt could figure quite centrally in economic and market machinations over the coming six months. Three potential inflection points merit particularly close examination. First is the November 6 election. Second is the "fiscal cliff" that strikes at the end of 2012 – a host of expiring tax cuts and stimulus programs, some of which must be extended to avoid recession. Third is the early-2013 rendezvous with the U.S. "debt ceiling" – an artificial cap on Treasury Department bond issuance that needs to be lifted for continued deficit financing.

These three items matter enormously by themselves, but are also interconnected (Exhibit 1). The election results will partially determine the path taken on the fiscal cliff and debt ceiling. The debt ceiling is likely to be held hostage for leverage in the fiscal cliff negotiations. As a group, they threaten to derail the U.S. economic recovery if not handled with finesse.

In the pantheon of economic risks, Europe's sovereign crisis still warrants top billing, and China's hard-landing risks arguably merit second place. But the triumvirate of U.S. politics, policy and debt are justifiably ensconced in third.

Fortunately, we have a relatively optimistic take on these events, anticipating that they will be handled in a sufficiently deft fashion that recession or enduring market distress is avoided. In fact, there is a fair chance that financial markets end up stronger by the time the last chapter is written.

Exhibit 1: Interconnected Events



Source: RBC GAM

Political discord makes resolution hard...

These three events are especially momentous because the U.S. and global economies are presently quite fragile, and because U.S. political discord is unusually high. This discord is arguably the result of three things:

1) Political structure

First, solutions have been hard to come by due to the structure of the U.S. political system. Extensive checks and balances have arguably been a virtue since the country's inception. But when policy heroics are required – like today – those checks and balances sometimes feel more like shackles. In addition, the endless two-year campaign loop in the House

of Representatives has done much to put the focus on short-term political gain and political differences rather than commonalities. The gerrymandering of election districts means increasingly that the real battle is over the nomination, not the election, leading to more ideologically extreme candidates. The arrival of the 24-hour news cycle and the occasional blurring of journalistic and editorial lines have further deepened the divide.

2) Structural transition

Second, this is a period of structural transition. Demographic trends and economic growth have become less favourable relative to earlier decades, as prior tailwinds cease to blow and as new headwinds mount. This metamorphosis was underway even before the financial crisis struck. In turn, the fragile policy truce between Republicans and Democrats over the past half century – tax cuts for the former, expanded government spending for the latter – is simply no longer tenable. At best, one or the other is now possible; at worst, neither is. Politicians have been slow to come to this understanding.

3) Financial crisis aftermath

Third, financial crises spark discontent. Economic weakness sets a grim mood. Tellingly, the misery index – the sum of the unemployment rate and the inflation rate – usually rises (Exhibit 2). Stoking the fire, the media saturates the public with bad news. In grappling with the crisis, policymakers are forced to undertake unconventional means of stimulus, and make sweeping regulatory changes. These actions benefit some, but hurt others.

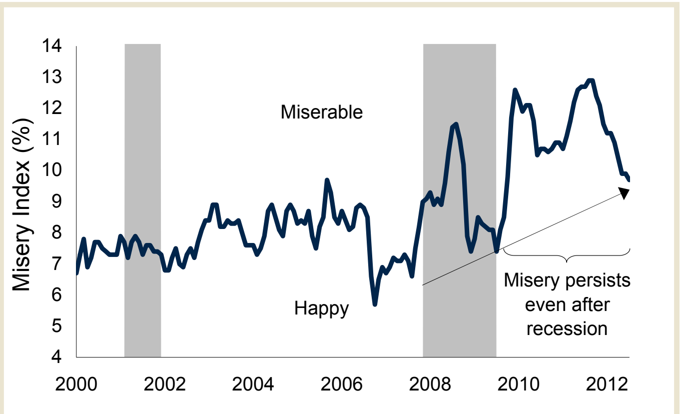
In this fetid atmosphere, basic assumptions about the economic system and public policy begin to be questioned. Political incumbents frequently suffer at the ballot box.

Most of these symptoms have appeared in the aftermath of the financial crisis of 2007–2009. Virtually every European election has swept the incumbent from office.

In the U.S., satisfaction with politicians has fallen materially (Exhibit 3). Congressional approval is never particularly high, yet it has fallen by more than half since June 2007. Presidential approval has similarly tumbled. First it was President Bush, whose approval rating soured steadily as the financial crisis erupted. More recently it has been President Obama, whose approval rating has dipped as the malaise has persisted.

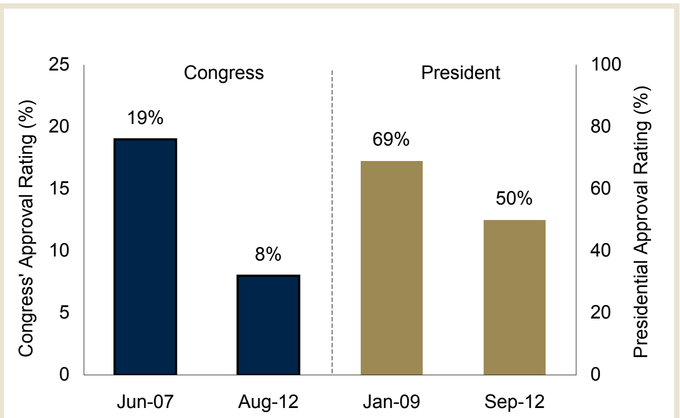
Protest factions have sprung forth, with the Tea Party on the right and Occupy Wall Street on the left agitating for more extreme political and policy changes. This puts pressure on the Republicans and Democrats to veer away from the centre to appease these groups.

Exhibit 2: U.S. Economy Is Improving, But Still Miserable



Note: The misery index is a proxy for economic unhappiness, calculated as the annual change in CPI plus the unemployment rate. Shaded areas are recession periods. Source: Haver Analytics, RBC GAM

Exhibit 3: Public Unrest Dampens Political Approval



Source: Rasmussen Reports, Gallup, RBC GAM

Divergent views

Republicans and Democrats have never operated in perfect harmony, but these three sources of discord have now created a perfect storm of opposing policies. The ideological gulf between the two parties in the House of Representatives is the greatest since the turn of the 20th century (Exhibit 4). The Senate divergence has also widened (Exhibit 5). Usually, a clutch of moderates act as power brokers, helping to secure mutually agreeable policy. This group has practically vanished: there is virtually no ideological overlap between the left-most leaning Republicans and the right-most leaning Democrats.

These disagreements have recently been put into even starker relief by the inevitable partisanship of election campaigning.

...but not hopeless

Given the level of political discord, there is much to be fretful over as the election, fiscal cliff and debt ceiling near. Politicians with such contrary dispositions will obviously struggle to achieve momentous bipartisan goals such as agreeing on a credible roadmap for a return to fiscal sustainability.

But the fiscal cliff and debt ceiling ask for very little. All they demand is to be kicked down the road by a year or two. With this as the humble goal, the situation may not be quite as dire as it looks, for four reasons.

First, the political divide should become less extreme once the election fever has broken.

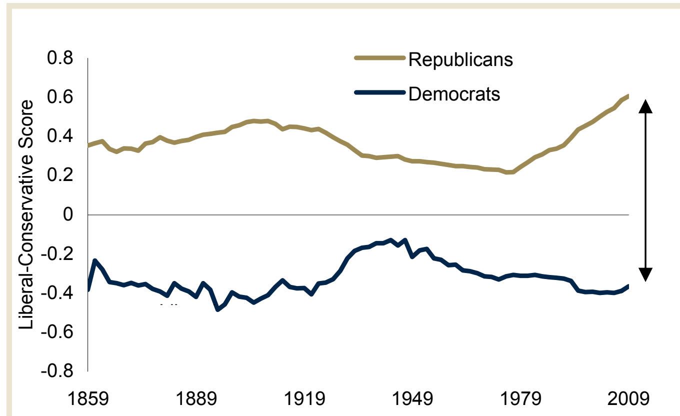
Second, elections usually seem more momentous than they truly are. Rarely do they mark a major, let alone permanent shift in policy. Politicians tend to tack to the centre once elected, reducing some of the contrast between initially divergent policy platforms.

Politicians also tend to be pragmatists, meaning that they operate within the realities of the situation. Studies find that Presidents exert surprisingly little influence over public opinion. To the contrary, it is they who are buffeted by the winds of public opinion and external events such as wars, recessions and societal change.

Third, despite their differences and perceptions to the contrary, American politicians have managed to broker quite a number of financial deals over the past few years. It is frequently a bumpy ride, but they eventually reach their destination:

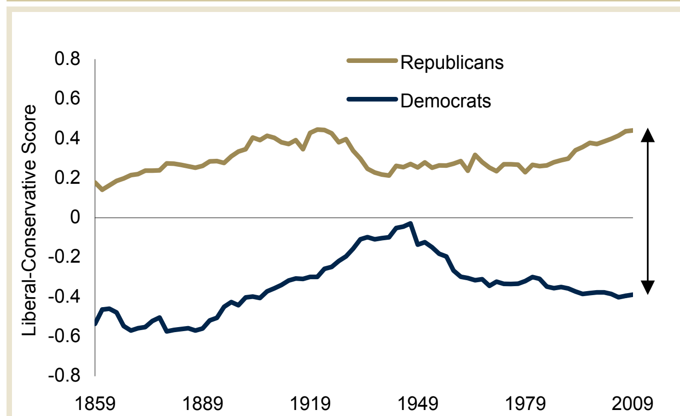
- Politicians initially rejected the TARP package of 2008, but quickly came to their senses when they saw the financial market fallout, passing it shortly thereafter.
- U.S. politicians reliably postpone a mini-fiscal cliff each and every year that includes such items as the Alternative Minimum Tax.
- The previous debt ceiling was lifted before a technical default could occur.
- The budget "supercommittee" failed to agree upon a fiscal roadmap in the fall of 2011, but only because the consequences were insufficiently severe: the punishment of "automatic" austerity beginning in 2013 is likely to be delayed as part of fiscal-cliff negotiations.
- In February 2012, politicians managed to pass extensions to the payroll tax cut and unemployment benefits.

Exhibit 4: U.S. House Becomes More Partisan in Recent Years



Note: Median score for each party's members in House of Representatives.
Source: Voteview.com, RBC GAM

Exhibit 5: Similar Divergence in the U.S. Senate



Note: Median score for each party's members in the U.S. Senate.
Source: Voteview.com, RBC GAM

- Politicians are on track to shortly pass a bill to avoid a government shutdown before the spring of 2013.

Fourth, it is crucial to understand that America's fiscal cliff is self-imposed by lawmakers, and thus artificial. They can just as easily defer it, and are ultimately likely to do just that.

Election 2012

With each party's nomination convention out of the way, the campaign is now in the home stretch.

Election probabilities

Political prediction markets say the U.S. House of Representatives has an 89% probability of remaining in

Republican hands (Exhibit 6). This is sufficiently high that we disregard the scenarios involving a Democrat House. That cuts the possible permutations in half.

The Senate currently tilts toward the Republicans (Exhibit 7), whereas the Presidency currently tilts toward the Democrats (Exhibit 8).[1] This means that the scenario of a Democrat President, Republican Senate and Republican House (DP/RS/RH) is the single most likely outcome. However, at just a 30% probability, it is necessary to consider alternatives as well (Exhibit 9). We focus on the four most likely scenarios (DP/RS/RH, DP/DS/RH, RP/RS/RH and RP/DS/RH, in that order of likelihood) for the purposes of discussing the likely market response to the election, below, and later in evaluating the difficulty of shrinking the fiscal cliff.

Election consequences

The election outcome matters for two reasons. First, it is likely to affect the contours of the fiscal cliff and debt-ceiling negotiations. More on this later.

Second, it may affect financial markets directly.

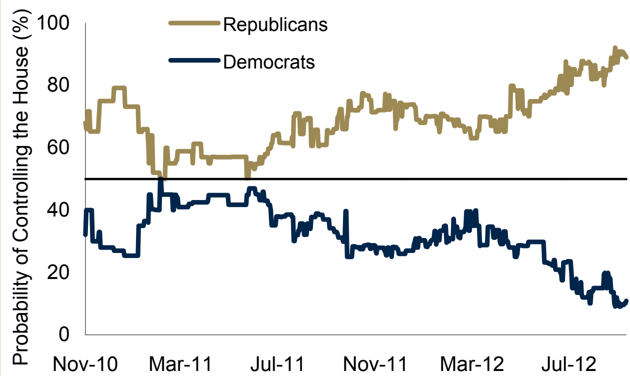
Beginning with a very short-term perspective, history shows that the U.S. stock market tends to rise in the final weeks of a Presidential campaign, regardless of the eventual victor. But returns frequently diverge immediately after the election, favouring a Republican victor over a Democrat one.

However, the market's favour proves fickle. By two months after the election, stock returns have on average flipped such that they are superior under a Democrat victor. This remains true right through to the end of the four-year Presidential term (a median S&P return of +11.4% per year for Democrats, versus +8.6% for Republicans).

The stock market tends to prefer the re-election of the incumbent. In this election, that favours President Obama. On the other hand, policy platforms also matter, and Governor Romney's platform is perceived to be more investor- and business-friendly. It is unclear which of these two effects will subsume the other.

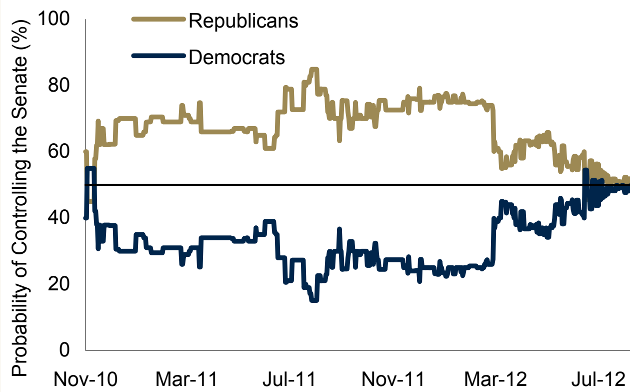
[1] Some may express surprise that President Obama has a discernable lead over Governor Romney, given that several polls put them neck-and-neck. One possible explanation for the difference is that the electoral college composition favors President Obama. That is to say, he doesn't need to be leading in the nationwide polls to secure victory.

Exhibit 6: Republicans Are Poised to Retain the House



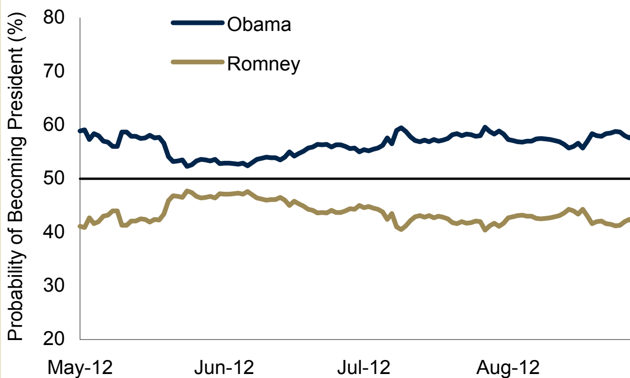
Note: As at September 12, 21012. Source: InTrade, RBC GAM

Exhibit 7: Republicans Hold Slight Lead in Senate Race



Note: As at September 12, 21012. Democrat figure is set to be inverse of Republican (due to assumption that independents caucus with Democrats). Source: InTrade, RBC GAM

Exhibit 8: U.S. Presidential Election Odds



Note: As at September 12, 21012. Source: InTrade, RBC GAM

On a medium-term basis, the first year after a Presidential election tends to enjoy above average stock market returns – the second best out of the four year cycle.

Broadening this analysis to include the four most likely President/Senate/House permutations discussed earlier, our findings are mostly favourable (refer again to Exhibit 9). Promisingly, two of the combinations have historically yielded very good market returns (DP/RS/RH and RP/RS/RH), a third (DP/DS/RH) has generated decent returns, while the fourth combination has historically done quite poorly (RP/DS/RH, though in fairness this represents a single unfortunate time period: 2001 to 2003).

To conclude, stock-market investors with a medium-term investing horizon should feel cautiously positive about the election.[2] The first year of the Presidential cycle tends to yield decent returns. It is beneficial that the incumbent President is leading in the polls and that a Democrat is leading the Presidential race. Finally, the single most likely election combination – DP/RS/RH – has historically produced excellent stock market returns.

Fiscal cliff

Through a mix of happenstance and design, an enormous number of U.S. tax cuts and government spending programs are scheduled to expire en masse at the end of 2012. This is widely referred to as the "fiscal cliff," because government support for the economy will fall off a veritable cliff next year if these programs are not renewed (Exhibit 10).

It is useful to understand where this fiscal drag is coming from. On the way up, every dollar of new stimulus adds to economic growth. This is widely understood. Less widely understood is that the opposite phenomenon – a fiscal drag – doesn't just occur when governments slam on the brakes. It also happens when policymakers simply stop pressing on the stimulus gas pedal.

No one debates that this fiscal drag must eventually hit. It is inescapable – stimulus cannot continue forever. The question is more one of timing and degree. When can the economy handle the hit, and can the stimulus withdrawal be spread across multiple years to soften the blow? How should this need for short-term economic growth be balanced against the no less crucial aim of long-term fiscal sustainability (Exhibit 11)?

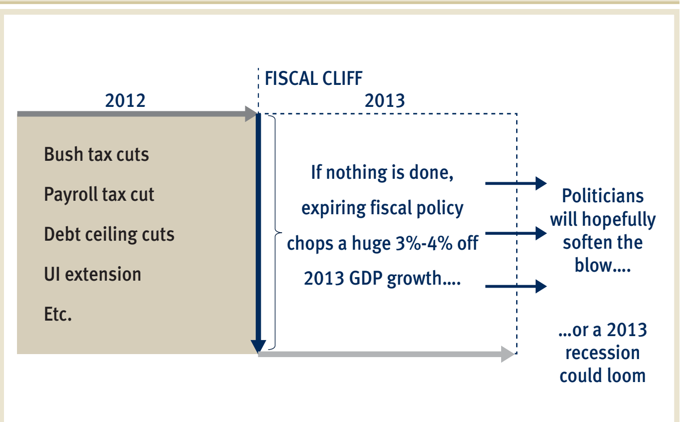
[2] However, it is important to understand that election-based investing provides inconsistent returns. With only one data point to collect every four years, there simply isn't enough historical data for reliable signals to exist. This information should only be used as a secondary investing aid, as opposed to a primary driver.

Exhibit 9: Elections and S&P 500 Returns

President	Senate	House	Odds	Median S&P 500 Annual Return	
Democrat	Republican	Republican	28%	27.0	LIKELY
Democrat	Democrat	Republican	26%	9.1	LIKELY
Republican	Republican	Republican	18%	12.8	LIKELY
Republican	Democrat	Republican	17%	-18.4	LIKELY
Democrat	Republican	Democrat	3%	N/A	UNLIKELY
Democrat	Democrat	Democrat	3%	9.0	UNLIKELY
Republican	Republican	Democrat	2%	9.0	UNLIKELY
Republican	Democrat	Democrat	2%	8.1	UNLIKELY

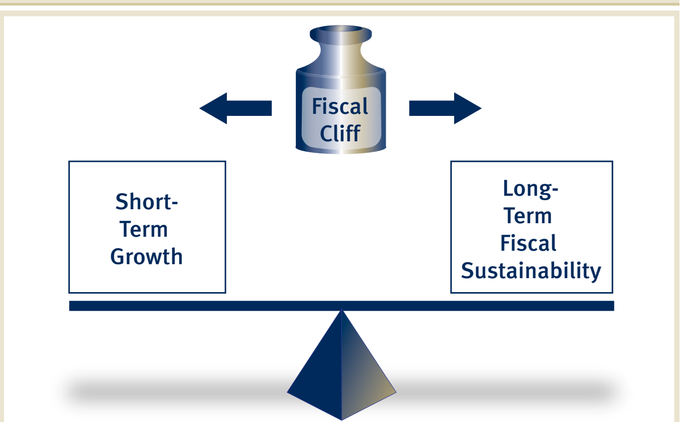
Note: Odds as at September 12, 2012. Data from 1960 to 2011. "N/A" means that political permutation has not occurred since 1960. Source: InTrade, RBC GAM

Exhibit 10: Fiscal Cliff Threat



Source: RBC GAM

Exhibit 11: Balancing Act



Source: RBC GAM

Politicians have not clearly answered these questions, but they do appear to agree on one thing: it would be madness to allow the full brunt of the fiscal cliff to strike in 2013 given the high probability that it would result in a recession.

Timing

From a timing perspective, there are four ways the fiscal cliff may be addressed (Exhibit 12):

A) **Fix before election (5% chance):** It is quite unlikely that politicians will fix the fiscal cliff before the November 6 election. They are too busy campaigning; the bickering would be unpopular with voters; they may hope to have better leverage after the election; and there simply isn't enough urgency.

B) **Fix during lame-duck session (50% chance):** The most likely scenario is that politicians address the fiscal cliff after the election but before the end of the year. There is a strong incentive to act before the fiscal cliff strikes; market pressure may build as the year comes to a close; the level of political discord may decrease after the election; lame-duck sessions are frequently quite productive.

C) **Fix in early 2013 (35% chance):** The second most likely scenario is that politicians deal with the fiscal cliff in early 2013, once the new Congress and (new or current) President are sworn in. Should the election result in a substantial shift in the balance of power, this scenario becomes much more probable as the victors would wish to negotiate at full strength. While it would give the market conniptions to wait until past the fiscal cliff deadline, some deft manoeuvring would allow for a retroactive fix.

D) **No fix (10% chance):** There is a slim chance that political dysfunction is simply too great and politicians are unable to compromise. This "Thelma & Louise" scenario – driving right off the cliff – would probably result in a mild to moderate recession from the fiscal drag.

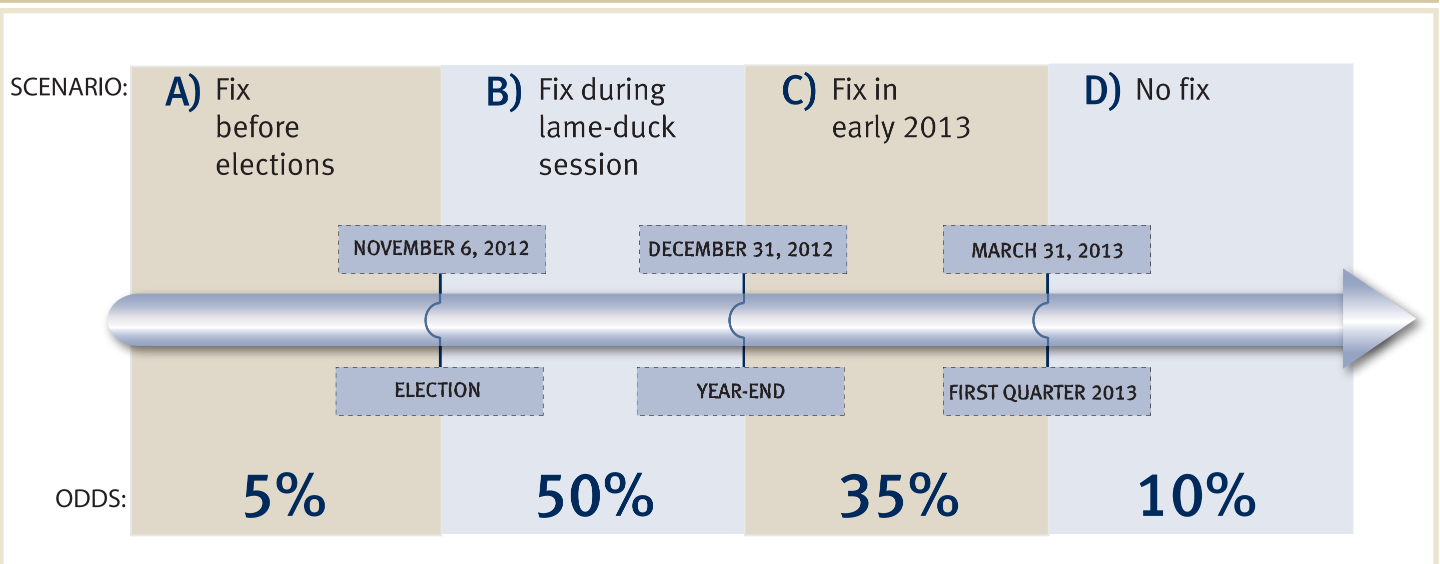
Policies

A whopping US$750 billion in spending programs and tax cuts are set to expire at the end of 2012 (Exhibit 13). These can be categorized into four groups.

First are the recurring items that are always renewed, like the Medicare reimbursement (which ensures that doctors don't see their Medicare reimbursements slashed), the Alternative Minimum Tax (which is not indexed for inflation and therefore must be manually adjusted each year to avoid colliding with tens of millions of Americans) and a variety of targeted tax provisions ("tax extenders") that require annual renewal. Barring total deadlock, these will be renewed, evading a $90 billion fiscal drag.

Second are the items that are set to expire without much fuss. This includes the original targeted debt-ceiling cuts (from August 2011, not the subsequent November 2011 automatic cuts). This group also includes some old stimulus programs breathing their last breaths, like lingering bits of the 2009 American Recovery

Exhibit 12: Fiscal Cliff Time Line



Source: RBC GAM

& Reinvestment Act. Lastly, it includes a further spending drag as the U.S. pulls out of Iraq and Afghanistan. Collectively, these represent $120 billion of fiscal drag that will hit in 2013.

Third is a non-recurring item that should be renewed. Both parties wish to extend the Bush tax cuts for those with incomes under $250,000. This averts a massive drag of $200 billion.

Fourth are the tough ones: the remaining $340 billion of programs that the two parties do not agree upon. Here is the main debate for each:

Bush Tax Cuts (>$250,000): The Republicans would like to extend the Bush tax cuts for those earning more than $250,000 per year, whereas the Democrats are firmly against it. This is worth $60 billion in 2013.

Payroll Tax Cut: The Republicans would like to end the two-percentage-point payroll tax cut, whereas the Democrats appear to have mixed feelings, perhaps only partially scaling back the program. This is worth $120 billion in 2013.

Automatic Debt Ceiling: This is also known as the Budget Control Act, or Sequestration. When the budget supercommittee failed to deliver the necessary budget cuts in November 2011, automatic triggers were set. These will cut military spending by 10% and Medicare/discretionary spending by 8% in 2013. Neither party wants these cuts, but they differ over when and where the shortfall should be made up instead. The Republicans would like to see subsequent spending cuts take up the gap. The Democrats would like to see a mix of spending cuts and tax increases. These are worth $100 billion in 2013.

Unemployment Insurance: Extended unemployment benefits have already begun to ebb, but will drop more drastically in 2013. The Republicans appear prepared to let these expire. The Democrats have a mixture of views, but overall seem to want to temper the speed at which the program is scaled back. This is worth $40 billion in 2013.

Health-Care Reform: The taxes that are designed to fund the Affordable Health Care Act ("Obamacare") are set to arrive in 2013. The Republicans would like to repeal Obamacare, while the Democrats wish to keep it. This is worth around $20 billion in 2013.

Scenarios

We frame the fiscal-cliff consequences using three illustrative election permutations (refer to the final three columns of Exhibit 13).

1. **Republican Sweep:** A Republican political sweep of the Presidency, the Senate and the House of Representatives

Exhibit 13: Fiscal Cliff in Numbers

	Theoretical Size ($B)	Republican Position	Democrat Position	Republican Sweep	Democrat Sweep	Split Government	
Medicare Reimbursement	20	Renew	Renew	0	0	0	
Alternative Minimum Tax	50	Renew	Renew	0	0	0	
Tax Extenders Expiry	20	Renew	Renew	0	0	0	
Original Targeted Debt Ceiling Cuts	40	Expire	Expire	40	40	40	
Old Stimulus Expiry	40	Expire	Expire	40	40	40	
Overseas Military Drawdown	40	Expire	Expire	40	40	40	
Bush Tax Cuts Expiry (<$250K)	200	Renew	Renew	0	0	0	
Bush Tax Cuts Expiry (>$250K)	60	Renew	Expire	0	60	0	IN PLAY
Payroll Tax Cut Expiry	120	Expire	Mixed views	120	60	60	IN PLAY
Automatic Debt Ceiling Cuts	100	Delay; arrange later spending cuts	Delay; arrange later tax hikes / spending cuts	30	30	30	IN PLAY
Unemployment Insurance Expiry	40	Expire	Mixed views	40	20	20	IN PLAY
Health Care Reform	20	Cancel	Continue	20	0	0	IN PLAY
Total Drag	750			330	290	230	
As % of GDP	4.6			2.0	1.8	1.4	

Note: Figures and scenarios are rough estimates. Source: RBC GAM, CBO, GS, RenMac, BoAML, DB, Eurasia Group, ISI

has an 18% probability, and would likely result in about $330 billion of austerity in 2013. This outcome would see the Bush tax cuts extended on high-income earners and most of the automatic debt-ceiling cuts delayed. But the payroll tax cut, extended unemployment insurance and health-care reform would likely be repealed.

2. **Democrat Sweep:** A Democrat political sweep is quite unlikely (just a 3% chance), but is nonetheless a useful exercise in establishing the preferred Democrat positions. This would likely involve around $290 billion in austerity for 2013. This outcome would see the health-care reforms enacted; the Bush tax cuts on high-income earners cancelled; only a partial rollback of the payroll tax cut and the extended unemployment insurance program; and most of the automatic debt-ceiling cuts delayed.

3. **Split Government:** By far the most likely outcome, with a 79% chance, is that the parties will share power. Three of our four political scenarios (DP/RS/RH, DP/DS/RH, RP/DS/RH) fit within this heading. Fascinatingly, the resulting fiscal drag of $230 billion is the least extreme of the three scenarios. This is because each party would seek to make deals to sustain their own programs, resulting in a diminished overall drag.

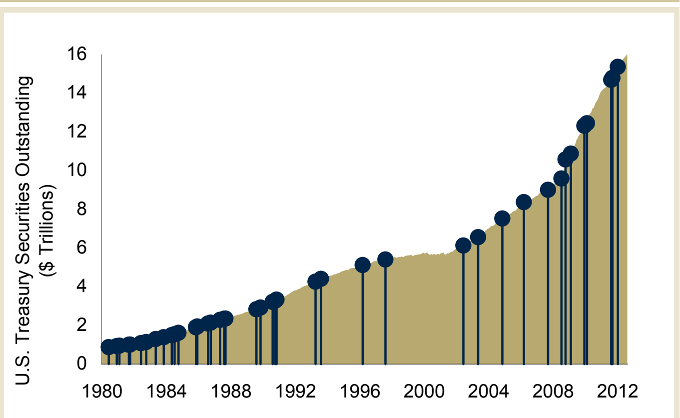
While we expect politicians to achieve a fix regardless of the election result, there is no question that some political permutations make this easier than others (Exhibit 14). Obviously, it is simplest to solve the fiscal fix in the event of a political sweep. At the opposite extreme, the most heart palpitations would result from a split between the House of Representatives and the Presidency since the House is especially ideological and possesses special powers on revenue bills, and the President enjoys a veto.

Exhibit 14: Political Scenarios

President	Senate	House	Odds	Fiscal Cliff Challenge	
Democrat	Republican	Republican	28%	Hard	LIKELY
Democrat	Democrat	Republican	26%	Hard	
Republican	Republican	Republican	18%	Easy	
Republican	Democrat	Republican	17%	Medium	
Democrat	Republican	Democrat	3%	Medium	UNLIKELY
Democrat	Democrat	Democrat	3%	Easy	
Republican	Republican	Democrat	2%	Hard	
Republican	Democrat	Democrat	2%	Hard	

Note: As at September 12, 2012. Fiscal Cliff Challenge refers to the likelihood of partisan squabbling. Source: InTrade, RBC GAM

Exhibit 15: Raising the Debt Ceiling Is a Common Occurrence



Note: Each dot represents legislative approval for an increase in the U.S. debt ceiling. Source: U.S. Treasury, RBC GAM

Debt ceiling

Last to strike of the three events will be the debt ceiling, likely toward the end of in the first quarter of 2013.

U.S. law imposes a debt ceiling beyond which the Treasury Department is not permitted to borrow without Congressional approval. Normally it is a simple matter to increase the debt ceiling whenever the debt load nears this limit. In fact, the government has done this dozens of times over the past three decades (Exhibit 15).

However, this benign process was seemingly turned on its head in 2011, when extreme partisanship resulted in a debt-ceiling standoff that was only broken at the 11th hour. In the wake of this frightening experience, it is easy to understand the jitters that many feel as the next bout nears.

Nonetheless, we suspect this next debt-ceiling debate will be less contentious than the one in 2011, for several reasons.

First – as with the fiscal cliff – this is an artificial deadline imposed by the very same politicians who are asked to resolve it.

Second, markets know that politicians eventually came through the last time, and that the market panic subsequently proved to be overdone.

Third, markets know that even if a ratings agency were to react to the political wrangling and lack of a long-term fiscal plan by downgrading the U.S. debt rating (as S&P did in August 2011 after the prior debt-ceiling circus), the bond-market

consequences would likely be close to nil. Compared with its peers, the U.S. still has a fairly high debt rating (Exhibit 16), and its status as the world's reserve currency remains a powerful trump card.

Fourth, even if politicians did miss the debt-ceiling deadline, the Treasury Department wouldn't immediately default on its debt. Instead, it would likely begin by selectively shutting down certain functions of government. In fact, this would be done in a strategic way so as to put maximum pressure on Congress to arrive at a rapid solution. The prospect of default is quite remote.

Fifth, there simply isn't much choice in the matter. Barring an instantaneous return to a balanced budget – which is quite impossible, by the way – the debt ceiling will have to be raised.

Sixth, the debt ceiling is likely to be paired with fiscal-cliff negotiations. Because the pressure will rise sooner for the fiscal cliff than for the debt ceiling, there is a fighting chance that the debt ceiling will be resolved in advance of the actual deadline.

Economic consequences

The election and fiscal cliff threaten to hinder the economy in two ways.

The most immediate economic channel is through the fog of policy uncertainty, which is unusually thick as these issues remain unresolved (Exhibit 17). Without a clear roadmap, businesses and households understandably elect to delay their spending. This partially explains the recent retreat in U.S. capital spending (Exhibit 18).

On the positive side of the ledger, confidence could enjoy a nice boost in 2013 once the election's victors articulate a clear vision for the future, the fiscal cliff is deferred and the debt ceiling raised.

The second economic channel is via the fiscal drag. The most likely fiscal-cliff scenario – a split government – would result in a fiscal contraction of 1.4% of GDP. This is just one-third the drag of the worst case scenario, yet still heavier than the 2012 hit (Exhibit 19) and worse than the experience in other parts of the world (Exhibit 20).

We employ a fiscal multiplier of 0.80,[3] meaning that a dollar of lost government spending subtracts 80 cents from the economy. In turn, this means that a 1.4% fiscal contraction should shave between 1.0 and 1.25% off economic growth in 2013.

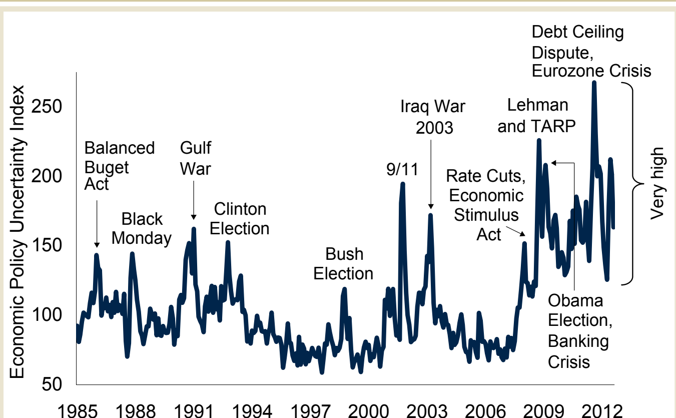
[3] This is higher than the fiscal drag traditionally employed by the IMF, but less than the assumption used by most forecasters for the fiscal cliff.

Exhibit 16: Don't Fret Debt Downgrade

World's 3 Biggest Economies	
Country	S&P Debt Rating
U.S.	AA+
China	AA-
Japan	AA-
World's 3 Biggest Bond Markets	
Country	S&P Debt Rating
U.S.	AA+
Japan	AA-
Italy	BBB+

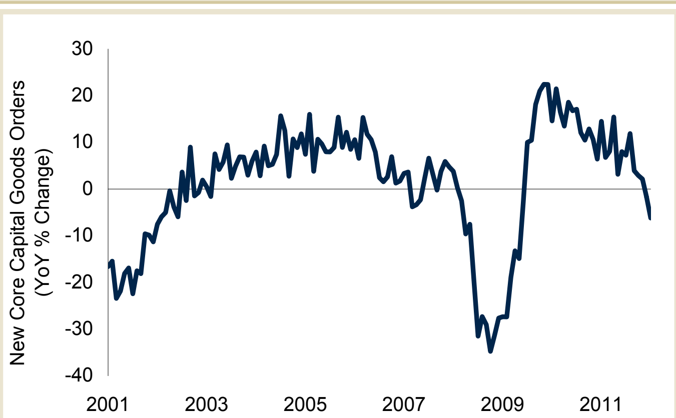
Source: RBC GAM

Exhibit 17: Policy Uncertainty Currently Quite High



Note: Index measures economic policy uncertainty by assessing news, expiring tax provisions, disagreement of forecasts for CPI and government spending. Mean of 100 from 1985-2009. Source: Economic Policy Uncertainty Index – Baker, Bloom and Davis, RBC GAM

Exhibit 18: Capital Spending Slides Lower on Policy Uncertainty



Source: Census Bureau, RBC GAM

It is tempting to simply subtract this figure from the recent economic trend of +2.0% per year, thereby arriving at a truly abject economic forecast. But this is not entirely fair.

The year 2012 suffered from a fiscal drag of nearly 1%, and yet is still on track for close to 2% growth. The economy would have grown materially more quickly without that drag. Moreover, there are other signs of life in the economy. We continue to detect important healing in the housing and credit markets that could yet unleash more growth. Monetary policymakers are again dishing out stimulus, whose maximum benefit will be felt in 2013. State and local government austerity is finally ebbing.

Given all of this, a more charitable interpretation is that in the absence of fiscal austerity the U.S. economy might have managed to grow by its long-term historical norm of 3.0-3.25% in 2013. With the austerity, we figure 2.0% growth is likely. This constitutes a modestly below consensus forecast, but not a disaster.

Market consequences

Right now, markets appear blissfully unconcerned with the approaching trio of events. Market volatility has been low, and predictive metrics point to more of the same (Exhibit 21). Perhaps this bliss will stubbornly persist.

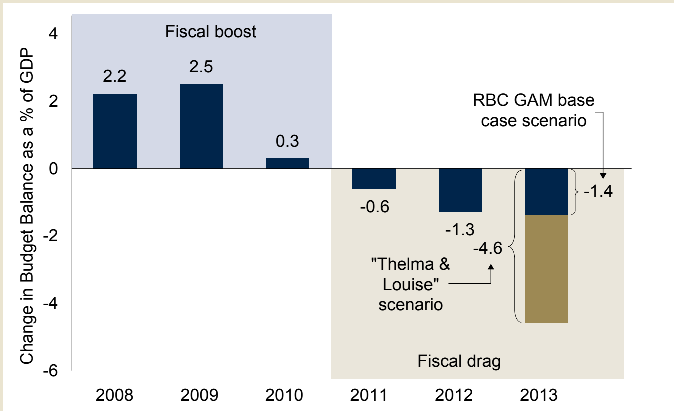
More likely, however, is that markets succumb to a little trepidation as these events come into focus and political theatrics build. Risk assets such as equities could suffer as investors favour safe havens such as government bonds.

But let us reiterate that we ultimately expect fairly benign outcomes for the election, fiscal cliff and debt ceiling. As a result, any market distress would likely be temporary.

In fact, there is a decent chance that markets will take kindly to the election results, the fiscal drag could be a little bit lighter than expected (due in part to greater cooperation in Congress, in part to our leaner fiscal multiplier), and the debt ceiling is unlikely to elicit an enduring market response. Even a possible debt rating downgrade in 2013 would be unlikely to sustainably affect financial markets.

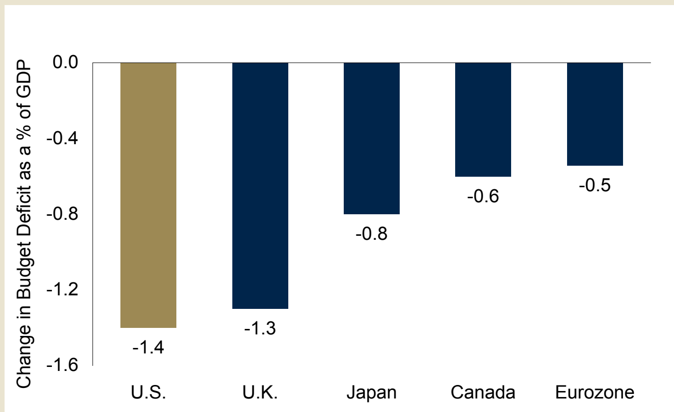
The bottom line is that while the fiscal cliff and its brethren continue to merit inclusion in a long list of things that could go horribly wrong for global financial markets, the odds of these actually triggering are quite low. This squares well with our broader worldview: the global economy itself may only be set for muted economic growth, but the big risks out there – European insolvency, a Chinese hard landing, the fiscal cliff – aren't quite as overwhelming as they first look. This is a welcome relief.

Exhibit 19: U.S. Fiscal Contraction Mounts



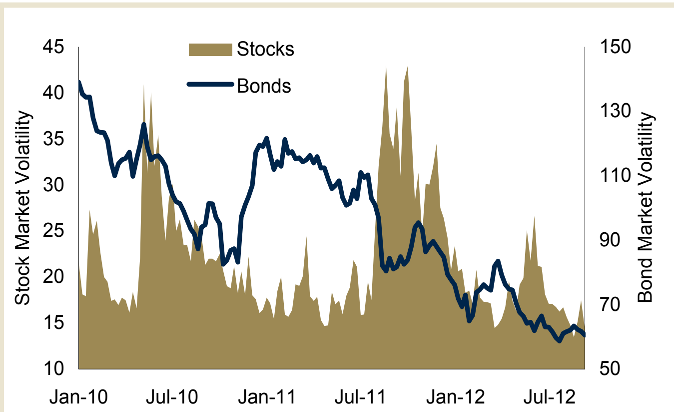
Note: A negative number indicates smaller deficit / bigger surplus versus prior year. Source: International Monetary Fund, Haver Analytics, RBC GAM

Exhibit 20: Projected Fiscal Contraction for 2013



Note: A negative number indicates a smaller deficit versus the prior year. Eurozone drag likely to be larger than IMF projections due to weaker than expected economies. Source: International Monetary Fund, Haver Analytics, RBC GAM

Exhibit 21: Market Volatility Expected to Take a Holiday



Note: Stock market volatility measured by U.S. VIX. Bond market volatility measured by U.S. Swaption Volatilty 1Y5Y Normalized. Source: Bloomberg, RBC GAM

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