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Letter from Washington

Presidents of the United States fortunate enough to be elected to a second four-year term have a limited period of usefulness in which to accomplish anything significant. From the time of the reelection there is an 18 month window when the President's power and influence are the greatest, and the potential for big things is highest.

Once that initial productive period has passed, the President then becomes focused on politicking for the mid-term elections in year two. Year three is when the President becomes concerned with his legacy, and usually turns to international affairs, often the Israelis and Palestinians and usually without positive results. The last year is spent working a deal for memoirs, tin-cupping for the Presidential library and pardoning friends.

President Obama is only the 20th US President to serve a second term, and the four most recent two-term predecessors all had significant stumbles in their second terms. Part of the problem has sometimes been over-reaching through arrogance, and sometimes that the first team of cabinet officers and advisors has departed and the B-Team isn't yet up to the job.

So it seemed strange then that President Obama chose to use his inaugural address as an opportunity to spike the ball in the end zone, rather than to reach out to the people that he will need if he is going to accomplish anything significant in 2013-14.

"On this day, we come to proclaim an end to the petty grievances and false promises, the recriminations and worn-out dogmas that for far too long have strangled our politics." After saying those words, the President then ticked off a laundry list of big ticket Democrat-loved programs that stand very little chance of passing a divided Congress, and took a couple of swipes at Romney and Ryan. Much like his campaign, which was a patchwork of small-bore programs without a unifying theme, the second term appears to be following suit.

In fairness, the hand that Obama has been dealt has resulted in the country careening from one self-induced crisis to another. The "fiscal cliff" deal that was struck at the end of the 2012 averted the worst of the tax consequences, but did nothing about sequestration except delay it for two months. The House Republicans apparently have realized that threatening to

not increase the national debt limit is a an issue on which they lose badly, so they created some breathing room by allowing the Treasury to continue borrowing until sometime in the late summer. However, sequestration and the end of the Continuing Resolution both come due in March, and there appears to be little in the way of compromise on either issue. All of this cries out for a "grand bargain" that reduces the deficit, reforms the tax code, and curtails government spending. Unfortunately, none of this seems achievable in the current climate of tactical skirmishing.

Rather than attempting to address the major fiscal issues in an adult manner, the Obama administration is still in campaign mode and appears to be trying to distract and divide with a series of shiny objects to split the House Republicans:

- The timing of the gun control debate was pushed forward by the Newtown school shooting, but as a highly divisive issue could not have been worse.
- Immigration reform has the potential to cause a serious split among the Republicans, further alienating the Hispanic constituency that is needed for national political revival.
- Climate change legislation did not even come to a vote in the first term, so the Obama administration has been slowly implementing many of its features by executive order and agency regulation.
- Dropping the legal barriers to women serving in combat roles is an inflammatory issue, but not a pressing one as the war in Afghanistan runs down.

Rather than acknowledging that these are all serious issues that deserve thoughtful discussion and debate, they have become a series of bumper stickers that distract from the fiscal issues. The times require genuine leadership and prioritizing that only the President can provide in the US system, but he appears to be quite happy to allow the oxygen to be sucked out of the room by these peripheral issues.

The failure of the parties to agree to a plan for reducing the deficit in 2011 was based on the belief that sequestration of funds would be so unpalatable to both sides that they would get serious and never allow it to take place. The agreement in the summer of 2011 resulted in spending caps that trimmed \$1T over 10 years from the federal budget, with an additional \$1.3T across the board if no equivalent level of reductions could be agreed in the interim. Since there has been no agreement, those reductions will take place on March 1.

To make matters worse for the DoD, what should have been an 8% reduction over twelve months now must be carried out in 7 months, so the effective reduction is more like 13%.

The President made "fairness" a key component of his reelection campaign, which resulted in the Republicans acquiescing to increased tax rates with no corresponding reduction in spending, as part of the fiscal cliff deal in January. Obama is trying to use the same leverage to force the Republicans to accept additional taxes as part of any new deal to avoid sequestration. House fiscal conservatives went along with the fiscal cliff deal based on the promise from the leadership that there wouldn't be any additional taxes considered, and that they would stand firm on requiring spending reductions as part of any deal.

Obama has always been very good at creating straw man arguments, and the sequestration discussion is no exception. The further tax increases that he is trying to extract from the Republicans are described as "eliminating a few special interest loopholes", and he has successfully captured the high ground in that argument as he did in the campaign.

With less than three weeks to go before sequestration occurs a couple of things are clear:

- First, the Republicans are not going to accept any deal that raises taxes again. Speaker Boehner could not even present a tax deal to his caucus without facing the certainty of another major revolt, probably ending his tenure as Speaker.
- Obama believes that the Republicans will take the blame for sequestration and that it is to his advantage to let it happen, looking ahead to the 2014 mid-term elections.
- The Republicans were beaten up badly in the presidential election on the issue of fairness, but they will not compromise on the tax issue again, especially in a deal that does not include large spending reductions. There is growing belief that the only way they can extract large spending reductions from Obama is by letting the sequestration mechanism occur.
- DoD does not have near enough reprogramming flexibility to absorb the impact of sequestration without major damage and disruption. It has been pointed out that the irony of the situation is that the civilian managers having to make the programmatic trade-offs would have to be doing so when not on furlough.

The members of Congress have been listening to the chorus of doom from the defense industry, but the market hasn't seen it that way. Defense stocks have done well by and large in the 4th quarter of 2012 and into 2013, partly

because DoD pushed a number of major contracts out early in 2012 in anticipation of sequestration, and partly because the decline in defense dollars has not become apparent in either order book or profits yet. Clearly the market has not priced in sequestration as the averages have all hit all-time highs in the first six weeks of 2013.

At this point, although there may be some eleventh hour deal to postpone sequestration again without resolving the underlying issues, it seems most likely that sequestration will occur and that \$492B will be taken out of defense across the board over the next ten years. It seems likely that there will be no agreement before March 1st, but that shortly afterward there will be some flexibility accorded to DoD to reprogram funds and reshape the reductions more favorably.

DoD has little option with only 7 months left in FY 2013, and will have to go after the budget items that result in this-year savings. Those things are mainly personnel and operations and maintenance. As a result DoD will maintain the hiring freeze, but also reduce contractor support wherever possible. Ultimately, defense government employees will have to be sent home without pay for as much as 45 days this year. The other two big pots of money are in readiness --- flight hours and steaming days, and in deferring scheduled maintenance and overhauls.

The President has another opportunity on February 12th to try to bridge the gap between Democrats and Republicans when he addresses a joint session of Congress. Article II of the US Constitution requires the President to inform the Congress of the state of the union "from time to time", which has come to mean yearly in January or February. In modern times Presidents have used the address as the opportunity to set lofty goals and focus the country on national issues, in preparation for the submission of the administration's budget.

In his previous four addresses the President has set more of a partisan tone, even complaining about a Supreme Court decision. The fact that he is scheduled to make three campaign-style appearances around the country in the day after the address would lead one to assume that he is not going to make any effort at a compromise on sequestration.

At this point the best case scenario would have sequestration occur by default on March 1, and then have the worst effects undone by legislation that would give the DoD the ability to apportion the reductions in a more rational manner.

Little attention has been focused on the fact that the FY 2013 Continuing Resolution also expires at the end of March, and it represents the last major bit of leverage that the Republicans hold to force spending reductions.