



February 9, 2015

Letter from Washington

There have been all kinds of noteworthy events and developments since the last letter:

- The President delivered the annual State of the Union address.
- The FY-16 budget was rolled out and delivered to Congress.
- The Republican majority assumed control of the Senate.
- A new Secretary of Defense was selected.
- The revised National Security Strategy was delivered.

History will probably record the Obama presidency as a series of missed opportunities, and none may be larger in retrospect than the 2015 State of the Union. The President seems to be incapable of even the slightest hint of graciousness, and in an hour that was by turns preachy and snarky, gave the Republican majority little to hope for in terms of accommodation.

Ironically, many members were in the same seats in 2009 when President Obama delivered a lecture on the theme that "elections have consequences". Not apparently in his case, and the electoral repudiation that the Democrats suffered in 2014 does not seem to have had any consequence at all in his mind. Insiders reveal that he is convinced that those Democrats who were turned out by the electorate would have won if they had just run on his record of accomplishment instead of running away from it.

Generally when a President loses both houses of Congress he has three ways forward:

1. Swivel to foreign policy. Clearly foreign affairs have not been this administration's strong point (Syria, Ukraine, ISIS, etc.). Another irony noticed by some at the State of the Union was that Yemen, which was cited in last year's address as the administration's Middle East success story, was taken over by Shia rebels on the same day.

The only possible ray of sunshine from overseas comes from Jordan as the result of an atrocity. King Abdullah, incensed by the medieval burning of his ISIS-captured pilot, has decided to take it personally and take on ISIS militarily. Potentially Jordan might be the linchpin in a Sunni reaction that will provide the "boots on the ground" that the Obama administration desperately needs to do something decisively

about ISIS. Not lost on many was the decisive and resolute leadership displayed by Abdullah, contrasted with the President's chiding of Christians over the Crusades and the Inquisition. Drawing moral equivalence between the events of 1096 and 2015 seemed not just tone-deaf but a ludicrous comparison.

2. Coopt the other party's agenda. Obama could have chosen to adopt some of the Republican pet rocks, notably tax reform, which might produce some areas of agreement. Instead he has chosen to double down on the agenda repudiated by the voters, and presented a State of the Union address larded with new giveaways and higher taxes.

The President's biggest new idea is free community college for students meeting minimal criteria. While the policy objective of improving the skill level of the American work force might be reasonable, wrapping it up as a new government freebie not offset by any corresponding reduction, is a clear non-starter with the Republican majority.

Not only were the Republicans not given anything they could build consensus with, the President verbally bitch-slapped them by reminding the audience that he had won two national elections and was finished with politics.

3. Refuse to implement the other party's agenda. The Congress can pass laws but it requires the Executive Branch to carry them out. The President has the option of vetoing any legislation he doesn't like, but can also take the less confrontational, more passive-aggressive path of just ignoring those things he doesn't agree with. This is the other side of the coin of the President's Executive Order authority in which he has directed policy that the Congress did not pass. Here he just doesn't implement or enforce the laws he disagrees with.

Besides ensuring continuing gridlock and political paralysis, this is a riskier policy for a President to pursue. Making policy and regulation in the absence of Congressional action is dubious but debatable. Refusing to execute laws duly passed by the Congress is a violation of the oath of office and would surely result in an impeachment tsunami.

Following the State of the Union address by about a week, the administration forwarded the President's proposed FY-16 budget to the Congress. The 2011 budget caps are still the law of the land, and under those restraints the DoD budget should not exceed \$499B. The President proposes \$534B for defense, which sets up some interesting conflicts.

Most Republicans and many Democrats believe that the world has become a riskier and more dangerous place in the last twelve months, given Russian retro cold war policy and the rise of ISIS. More, not less defense spending is

in order, but the original reason for the budget caps has not gone away. The federal deficit in FY-2014 was \$486B, down by \$195B from 2013. While this shows some progress in balancing the budget, it is still a massive number to the deficit hawks. It is not clear whether the defense hawks or the deficit hawks will carry the day, but what is clear is that the Congress will continue to impede DoD efforts to streamline and become more efficient.

If the budget caps remain in tact, any defense budget above \$499B will initiate the mindless sequestration of funds repeating what occurred in 2013. At this point, it does not seem likely that there will be a meeting of the political minds capable of resolving the underlying structural issues that would result in the repeal of sequestration. The Republicans want to spend more on defense than \$499B but want the money to come from cuts in non-defense programs. The Democrats are fine with spending more on defense, but believe that the non-defense programs should be plussed up rather than cut.

The elephant in the room is that while the deficit decreased in 2014, discretionary spending was down but mandatory spending (Medicare, Medicaid and Social Security) increased as a percentage of the budget. Until the President and Congress agree to restructure the entitlement system, any budgetary action is just tinkering at the margins.

The President rolling out a series of new federal programs in the State of the Union does not set the stage for the adult conversation and hard choices that need to be made. In 2008 candidate Obama said that we could not continue to kick the fiscal can down the road. It appears that there will be no serious address of entitlement reform at least until there is a new President in 2016.

There will be a new Secretary of Defense shortly, and Ashton Carter, former Deputy Secretary appears to be bound for an easy confirmation. Just as with the federal budget, Carter will face a defense budget that is being consumed by rising personnel costs --- up 46% since 2000. This is an unsustainable trajectory, but the Congress has shown that it is not willing to allow the DoD to close bases or to retire aircraft and ships, in an effort to reduce operating costs. That unneeded infrastructure is estimated to cost the DoD \$70B over the next five years.

In fact, the Congress has not only blocked attempts at increasing efficiency, but continues to contribute to the problem by rearranging appropriation priorities. In FY-15 the Congress redirected \$5.6B to the administration defense procurement budget, mainly from Operations & Maintenance accounts. While increased procurement keeps production lines open in home Congressional districts, it comes at the expense of fuel, spares and ultimately readiness.

The one safety net that exists in the system for 2016 to avoid sequestration is the Overseas Contingency Operations (OCO) account. The OCO was

originally established in 2003 to pay for Iraq and Afghanistan war costs but has become a second source of procurement funding, rationalizing that equipment that was worn out by repeated deployments could be replaced by the off-budget funds. Another positive for DoD has been the dramatically reduced cost of petroleum products, which will help the readiness issues.

From an industry perspective, having the Republicans cut the President's budget by \$35B to stay under the caps is not optimal, but is preferable to the disruption caused by sequestration. The across the board cuts have resulted in program stretch-outs and cancellations that make industry investment strategy a pointless exercise.

The defense industry has weathered the first round of sequestration through shedding infrastructure and people, but has pretty much reached the limits of that strategy. The major primes have also reduced R&D spending by about 10%, redirecting cash to dividends and stock buy-backs, which have kept share prices moving up. This has been mainly a holding pattern for the industry while waiting for the fog to lift.

Merger and Acquisition activity picked up slightly in 2014, but not among the major players. The acquisitions that have occurred have been mainly smaller niche companies that can bring a unique capability to the corporate parent.

The rollout of the new National Security Strategy presented no surprises, and is more of an affirmation of the Obama administration's approach to the security policy of the last six years. The bottom line is that the US will take the long view of security strategy and not become distracted by current events. The long-term goal is not particularly clear, other than providing our allies and friends the means for them to fight terrorists on our behalf. The commitment of US forces will only be when US lives and territory are in danger, and the watchword is "strategic patience".

Predictably, critics of the President's foreign policy wonder why the US has not been forthcoming with both lethal and non-lethal support for the Kurds and Ukrainians, both of whom are fully engaged in combat operations in which the US has a significant stake in the outcome. Those cases would seem to fit the President's new statement of policy, unless "strategic patience" is a synonym for endless analysis, followed by inaction.

In any case, the new strategy seems to be more of a justification for the last six years than a blueprint for the future.