NOVEMBER 2012

# INVESTMENT UPDATE

The 2012 elections were a disappointment for those who might have been looking for a change in the Washington status quo. Barack Obama is still president. Republicans still have a solid majority in the House. Democrats retained control of the Senate. Obamacare remains in place. Financial reform legislation will not be reversed (especially galling to Wall Street, if not the entire banking and financial industry).

In the days immediately following the election the stock market sold off as investors voiced their apparent dissatisfaction with the election results. There is work to do right away on the US fiscal front, and at least one major bond ratings agency warned that a repeat performance of the congressional budget battles of mid-2011could lead to another downgrade in the bond rating of the US Treasury.

The pervasive gloom that hangs over it all is, of course, the dreaded "fiscal cliff."

The fiscal cliff! How can we possibly avoid it? Every news outlet is running an endless loop about its destructive potential! It's inevitable, it's unavoidable, it's a giant Death Star that looms over planet earth, ready to destroy us in a blaze of white hot laser-beamed annihilation!

Main Components of the "Fiscal Cliff" (2013 Calendar Year)

| | $ Billions | % of GDP |
|---|---|---|
| **Revenue Increases:** | | |
| Bush tax cuts, AMT | $300 | 1.9 |
| Payroll tax cuts | 110 | 0.7 |
| Other tax increases | 90 | 0.6 |
| ACA high earners tax | 20 | 0.1 |
| Total Revenue | 520 | 3.4 |
| **Spending Cuts** | | |
| Automatic/Sequester | 70 | 0.5 |
| Extend unemploy expire | 50 | 0.3 |
| Medicare savings | 10 | 0.1 |
| Total Spending | 130 | 0.8 |
| **Total Fiscal Cliff** | **$650** | **4.2%** |

And yet, and yet...

It might not be so. This election, as placid as the results may appear at a glance, has the potential to mark a significant change in the direction of US fiscal policy. And, let's face it, our fiscal policy is a disaster, with only our size and tremendous natural and human resources distinguishing us from the basket cases of Southern Europe. We have overpromised on what services we can provide to our own citizens and undercollected on the revenue we need to operate our economy. Per capita total government debt is $53,000 in the US—that's $14,000 higher than in Greece.

All this is known. Much, maybe even most, of the bad news is already priced into the market, and to some extent, into our economy. As we wrote in our September *Investment Update*, households and (especially) businesses have been sitting on their hands, unsure of what Washington will do with tax policies and employment programs; what will go and what will stay? When consumers and businesses don't have clear information on the future of US fiscal policy, decisions about spending, hiring, and investing are deferred.

To back up a bit, let's define what major programs and policies are scheduled to change after year end. The box on this page has a list of the four major changes in tax policy that will, without Congressional action, take place on January 1, 2013, as well as three major areas of spending cuts that will take place at the same time.

The first and largest change in tax policy will be the expiration of the so-called Bush tax cuts. You will recall that then-President George W. Bush, early in his first term, lowered income (and two years later, capital gains) tax rates across the board, with the provision that they would rise back to the Clinton-era rates in ten years' time. That expiration date was December 31, 2011, but late last year Congress voted to extend these lower rates one additional year. If left to expire, the total estimated increase in Treasury revenue (and cost to taxpayers) coming from higher tax rates is $300 billion for calendar year 2013. Also included in this figure is the expansion of the alternative minimum tax, which will apply to many more tax filers in 2013 than in previous years.

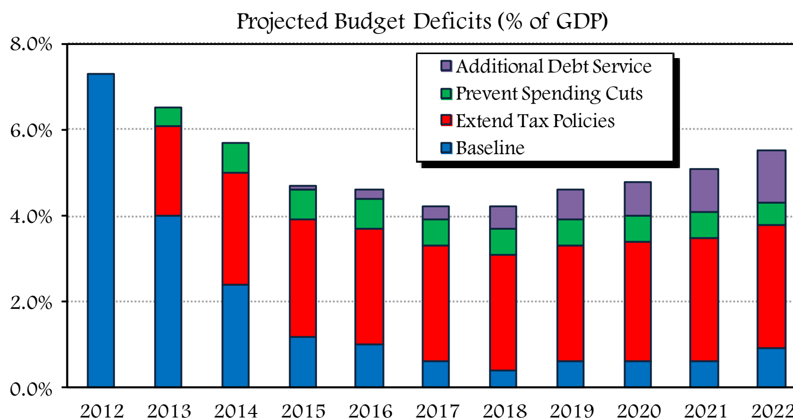
Other additions to Treasury receipts will come from the expiration of Social Security/payroll tax incentives (approximately $110 billion), the ACA ("Obamacare") high earners' tax ($20 billion) and a host of miscellaneous tax breaks ($90 billion). The total estimated increase in Treasury income from all of these is in the neighborhood of $520 billion in 2013.

In addition to higher taxes, there are mandated cuts in government spending that will also take place on January 1st. These include automatic cuts in both discretionary and non-discretionary government programs (but not Social Security or Medicare) dictated by last summer's debt ceiling negotiations (the "Budget Control Act of 2011"). The sequestering of government programs is estimated to reduce spending by $70 billion in 2013. Two other programs are due to expire: unemployment benefits for those out of work for an extended period of time, and certain Medicare reimbursement payments to doctors (the so-called "doc fix"). These are projected to save $50 billion and $10 billion, respectively, in 2013.

These numbers, supplied by the economics team at Deutsche Bank, are slightly different than those of the Congressional Budget Office, but offer the same conclusion: the 2013 budget deficit will be roughly cut in half, from $1.2 trillion, to $600 billion, if we "go off the cliff" and all these changes take place. And while deficit reduction should be a primary goal of our profligate government, the table points out that the monetary value of these cuts are equivalent to more than 4% of US GDP. For an economy that is growing at around 2%, these cuts, in totality, are sufficient to put us back into a recession.

The hope (which is fading quickly) had been that tax cuts, extended benefits, payroll tax relief, and a host of other programs that were either put in place or extended over the past few years would put the economy on solid footing. Once it had stabilized, the eventual removal of these programs wouldn't be detrimental, as there would be enough "organic" growth in the economy to propel us forward in the business cycle.

Unfortunately, the US economy continues to struggle in generating much growth, even though we've officially been out of the recession now for more than three and one-half years. The over-leverage of US households and the banking system's exposure to these borrowers amid a collapsing housing market has made this economic recovery the most anemic since the Great Depression. We are moving forward, and seeing some signs of a stronger housing market, but consumers remain wary, and businesses see no reason to increase their productive capacity, even with borrowing rates at levels not seen in more than fifty years.




As a result, policymakers are faced with unpleasant choices: cutting spending and raising taxes are, by definition, anti-growth. Fortunately, not all cuts and taxes are created equally. Nor are all these programs popular with a majority of the US population. Therefore the key (at least in the short term, and until policymakers and politicians are ready to enact true tax and policy reform) will be to identify the tax increases and spending cuts that will do the least damage, economically and politically.

This is the primary reason why President Obama is going after those in the highest tax bracket. Despite their significant political influence, they represent a relatively small part of the voting population, don't engender a lot of sympathy from the general public, and (most importantly) will provide the biggest bang for the buck from a fiscal standpoint. Compared to those of more modest incomes, higher earners save a larger percentage of their income while lower income families spend essentially all their after-tax income. With lower-income earners, if you raise their income tax rates, you get an almost dollar-for-dollar decrease in sales as a result of lower take-home pay, and a direct hit to the economy. Not so for those at the top of the earning scale; the government can bring in an extra dollar of tax money by raising their income tax and suffer only a fraction of lost sales as a result. Higher income earners are the "low hanging fruit," and are an easy target for politicians.

But we all know that just raising taxes on the rich really won't solve our fiscal problems; there simply aren't enough rich people to tax. As the chart on this page shows, if all the Bush tax cuts were eliminated at year-end (along with the payroll deduction benefit and indexing AMT), we would reduce the budget deficit in fiscal year 2013 from 7.3% of US GDP to around 4% of GDP. "Taxing the rich" (as President Obama's 2013 budget proposes) will only reduce the deficit by an estimated 0.6% of GDP. A closer look at the chart shows the CBO Baseline—where everyone's tax rates revert back to those of the Clinton era, and the 2011-mandated automatic budget cuts are all implemented, and with resulting interest cost savings from smaller deficits figured in—in this scenario, we nearly balance the budget in less than five years.

This baseline scenario is, in fact, what "going over the fiscal cliff" looks like from the standpoint of the US budget deficit. The alternative—kicking the can down the road, and allowing all tax rates to remain where they are, and not implementing budget cuts—means that we still run budget deficits no lower than 4% of GDP over the next few years. To put that into perspective, a 4% deficit in 2017 will be in the neighborhood of $825 billion. Further, additional interest costs on servicing these higher accumulated annual deficits begin to really bite, representing an additional 1% of GDP within ten years.

Obviously, continuing to run large deficits is as ruinous for the United States as it would be for any country. And, as we pointed out in the September *Investment Update*, half-measures will simply not do enough. Driving over the fiscal cliff, as suboptimal as it is, would not mark the end of the world. While small changes to the tax code and limiting the growth of government programs seem like a gloom and doom scenario, it's the kind of forced discipline that may be necessary for Congress and the President to finally take the issue head-on.

What we really need is a thorough examination and rationalization of our tax code; we need a code that generates sufficient revenue while also providing the right incentives for a productive and dynamic labor force. Likewise, social/retirement programs need to be modernized in order to fairly serve an aging population. Yes, these social programs are the "third rail" of US politics, where touching them is considered career suicide. Is this too much to expect from a second-term President who has run his last campaign?