Fiscal Cliff Battles

Market Perspectives

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Disaster Averted or Postponed?

The House, Senate and White House had all played up the idea that if the U.S. went over the fiscal cliff it would be a disaster for the economy. This message was picked up and amplified by the media and all politicians who could find a microphone. Washington eventually acts, although sometimes like the vote on the TARP program, it can come after a severe market selloff. In this case, the Senate and House decided to wait until the eleventh hour, with the Senate passing a measure on December 31st and the House following on January 1st. Certainly an interesting way for both parties to start the New Year.

Washington politicians knew it was in their best interest to come together to avoid a perceived disaster. The Congressional Budget Office (CBO) had projected that GDP growth would drop to a negative 1.0% from a positive 2.0% for 2013 if nothing was done. We had expected resolution to the fiscal cliff, if not before year-end 2012, then sometime in the first quarter. Though in this case, resolution has only been reached on the tax cut side of the issue, with the impact of the pending sequester simply postponed for two months. The grand bargain of raising revenue and cutting spending along the lines of a $4 trillion package over 10 years failed. A needed discussion on modifying entitlement programs was postponed again. The most popular issue on both sides of the aisle to deal with was making the Bush tax cuts permanent for most tax payers. Permanent is an interesting term when we discuss Washington. We did avoid the tail risk of not extending the tax cuts and potentially having investors sell off the stock market and businesses and consumers retrench. The risk of recession was reduced which is good for risk assets, including bond spread product.

Some of the key provisions of the final legislation are listed below:

- The Bush tax cuts were extended for households who file with less than $450,000 of income, or individuals with less than $400,000 (high earners).
- The tax cuts expire for those with higher incomes as the marginal tax rate rises from 35% to 39.6%. Including the effect of the phase out of various deductions, the marginal tax rate for some will be 41%. (U.S. Senate, WSJ).
- Higher earners will also see an increase in the tax rate on capital gains and dividends from 15% to 20%. An additional 3.8% will be applied from the ObamaCare surtax. In addition, there will be an increase in the Medicare payroll tax for households with taxable income over $250,000 of 0.9%.
- There will be limits on itemized deductions for households and individuals with income of $300,000 and $250,000 respectively.
- The social security tax holiday was not extended. All workers will face an additional withholding of 2%.
- The Alternative Minimum Tax was fixed for last year and will be indexed for inflation.
- The estate tax was raised to 40% from 35% and the current five million dollar exemption was extended, but will be adjusted for inflation.
- There was also a one year extension of unemployment benefits.
- Once again the "Medicare doc fix" was extended, which means no reduction in payments to medical providers for another year.

The final bill is supposed to bring in $600 billion over ten years. With much less fanfare the request for money for Hurricane Sandy will be passed. The request was for $60 billion and though something less than that will pass it will probably include some pork. The CBO estimates that the net increase in budget deficits from the fiscal package when compared to its baselines scenario (which has all tax cuts expiring) is about $4 trillion. All that means is the discussion regarding debt and spending cuts is still to come, most likely in February and March as the Capitol braces for the battle over raising the debt ceiling limit.

The increase in tax rates will be a drag on the economy. We expect GDP to grow at an annual rate of less than 2% for the first quarter and pick up in the second half of the year. This is below the long term growth expectations for the economy. The Fed reduced their long-term growth forecasts in early 2011, from a range of 2.5% to 2.8% to a range of 2.3% to 2.5%.

Sequester – Delayed Not Avoided

The sequestration spending cuts were postponed for two months. The spending cuts in the sequestration were supposed to be so unacceptable to both sides that they would reach a compromise and never go into effect. There will be a contentious battle over these cuts. There are some who do not want any of the cuts to go into effect. At the time these cuts were put into effect there was a concern that the ratings agencies would downgrade the U.S. Government debt. There was one downgrade from Standard and Poor's, but rates did not rise due to other currencies not providing a better safe haven than the U.S. In their research note of January 10, 2013 Moody's says: "the debt trajectory resulting from this process is likely to determine whether the Aaa rating is returned to a stable outlook or downgraded to AA1, as Moody's stated last September". There is a risk that Washington feels that a debt downgrade is not that significant and therefore they don't have to fix the deficit problem. This will lead to problems longer term.

Debt Ceiling Limit – One More Time

The public debt limit of $16.394 trillion was reached on December 31, 2012. The Treasury will take measures to bring total debt down enough to probably stretch through the end of February. The President has said he will not negotiate over the debt limit. Some Republicans, most notably Speaker Boehner, have said they want a dollar cut in spending for every dollar they raise the debt limit. This is one leverage point the Republicans have and they will be weighing the risk of using the lever versus being blamed for a government shutdown.
The battle over both the sequestration and the debt ceiling may lead to some volatile markets over the next couple of months. Even if the result is a one notch downgrade from Moody's and Fitch the world lacks an attractive currency that is large enough to absorb significant outflows from the U.S. Therefore we believe the rate reaction would not be severe. We continue to believe that spread product will perform well even though there will likely be volatility in the first quarter as each party publicly postures in the ongoing negotiations.

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