Avoiding A Fall Off The Fiscal Cliff.

By now, you've likely heard talk about the looming "fiscal cliff" the U.S. could be headed for in 2013. Financial commentators, politicians and the Congressional Budget Office (CBO) have weighed in with their predictions of what will happen if Congress doesn't act in time to avoid the automatic spending cuts and tax increases scheduled to take effect in 2013. The decisions of policy makers over the next few months will have a serious impact on the economy over both the short and long term.

It helps to understand exactly what the fiscal cliff is and how it was created. In August 2011, the country was nearing the debt ceiling, and our "do-nothing Congress" was living up to its name. Finally forced into taking action, the Budget Control Act of 2011 was passed in a deal between Congress and the President to raise the debt ceiling.

The legislation created a bipartisan "supercommittee" tasked with developing a plan to decrease the deficit by $1.2 trillion over 10 years. The law also stipulated that if the committee couldn't come up with a plan, spending cuts ("sequestration") of $110 billion a year for 10 years split between discretionary domestic and defense spending would begin in 2013. The idea was that these automatic cuts would be so broad and untargeted that both parties would find them repugnant and be motivated to reach an agreement. Unfortunately, the committee failed, setting the country up for another countdown to crisis.

Without any action, the spending cuts related to sequestration as well as a host of tax increases will occur in 2013. For a full breakdown of what some are calling "taxmeggedon," see the related article in this issue by Joanna Murphy.

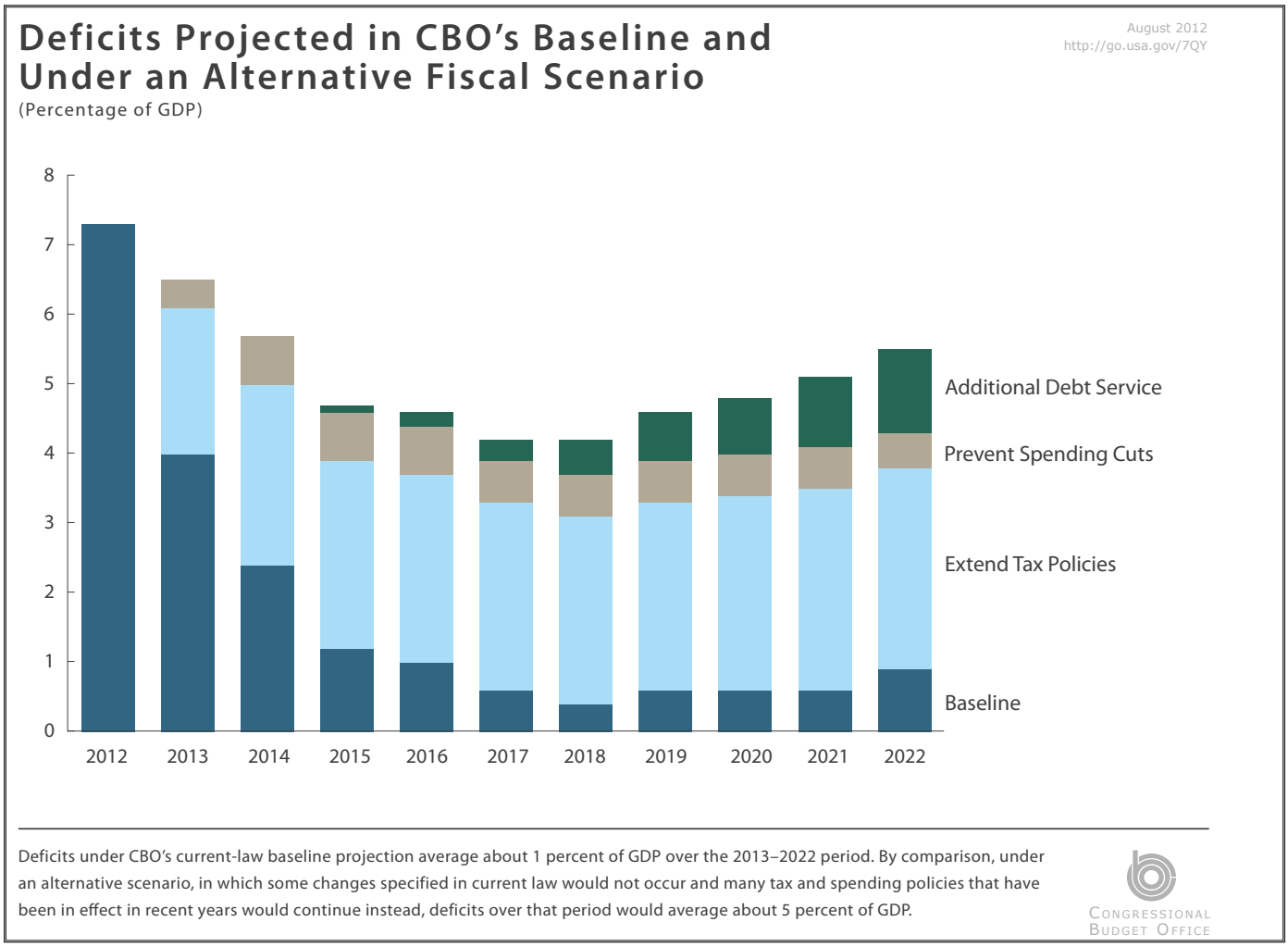
Effect on economy

Of course, it is possible that Congress and the President could act to avoid some or all of the scheduled changes, most likely in the lame duck session after the November 6th elections. But given the contentious political environment, it's important to at least consider the possibility of inaction. Consider that in September, Republican Speaker of the House John Boehner said that he was "not confident at all" that the two sides could come to an agreement and avoid the fiscal cliff.

The CBO analyzed the numbers and found that if Congress does take action and avoids the scheduled spending cuts and tax increases, the growth of real GDP in calendar year 2013 would be around 4.4 percent. If Congress is unable to act, and the changes take effect as scheduled, the CBO projects that GDP would grow an anemic 0.5 percent for the year, including a contraction of 1.3 percent over the first half of the year, possibly throwing the economy into recession.

While 4.4 percent GDP growth is obviously superior to half a percent growth, the CBO correctly warns that extending 2012 policies without a plan for future deficit reduction would put the U.S. on an unsustainable fiscal path. Indeed, there are fears that a lack of progress soon on the debt issue could lead to increased borrowing costs for the U.S. government. The accompanying chart on page 3 shows the lower annual deficit as a percentage of GDP if we go off the fiscal cliff (dark blue bars) relative to extending current policies (light blue, brown and green bars). As you can see, the deficit is projected to be much larger if the fiscal cliff is avoided, in no small part thanks to higher debt service payments.

However, as my colleague Corey Redington showed in his July Investment Perspectives article, the U.S. is not currently feeling much of a pinch from its payments on the national debt. In fact, thanks to historically low interest rates (and a lot of help from the Fed), the government's interest payments are currently consuming a smaller percentage of GDP than in 1992. That leads us to believe that Congress should take advantage of this window of opportunity to focus on economic growth in the short-term while putting into place a plan for deficit reduction in the long-term.



Monetary Action

While Congress and the President seem to be doing everything they can to make the environment difficult for businesses and investors, the Federal Reserve and its chairman Ben Bernanke seem to be doing the opposite. Indeed, it could be argued that Congress is doing too little and Bernanke is doing too much to compensate for the lack of fiscal action.

Bernanke's latest creation is QE3, a program announced on September 13 that will expand the Fed's holdings of long-term securities through purchases of mortgage debt at a rate of around $40 billion a month. This program comes on the heels of two previous rounds of quantitative easing that led to bond purchases totaling $2.3 trillion. The goal of QE3 is to keep interest rates low to support borrowing (particularly for home purchases and refinancing) in an attempt to stimulate growth and reduce unemployment. This round of quantitative easing is the first time the Fed has left the timing of the program open-ended, an unprecedented action even in the post-financial crisis era of extraordinary government intervention. The Fed also extended the date through which it "anticipates that exceptionally low levels for the federal funds rate are likely to be warranted" to at least mid-2015.

The stock market reacted positively to the announcement of the program, rallying to near multi-year highs. The sentiment wasn't universally positive however, as Richmond Fed President Jeffrey Lacker dissented, saying he opposed additional asset purchases. Others within the Fed argued

that continued easy money policy could stoke inflation. Judging by the stock market's response to previous rounds of QE, the post-announcement rally can be like a sugar high, which inevitably ends when market participants realize that monetary policy will not be a cure-all. It will take long-term fiscal solutions before a strong, sustainable recovery can take hold.

Effect on companies and investors

One unfortunate side effect of the short-term solutions enacted by both Congress and the Fed over the past few years is the uncertainty that has been created. After all, it is difficult for businesses to plan if they do not have good visibility into future rules and regulations. Uncertainty leads to scaling back or delaying projects and hiring, which can reduce profits, keep unemployment high, and depress stock prices. Consequently, the stock market could benefit from the increased certainty that would come from the election and subsequent action – or even inaction – from Congress. After all, by January 1, companies should know what the playing field will look like going forward and will be able to adapt their businesses as needed.

Perhaps even more than businesses, individual investors are facing a range of possible environments in 2013. For example, the dividend tax rate for higher-earning individuals could be as high as 43.4 percent if current rates are allowed to expire or as low as 18.8 percent if Congress acts to extend the existing rate. Capital gains, interest income, and the estate tax also could see increases ranging from moderate to severe. So what should investors consider as they move toward 2013?

Special Dividends: Just as individuals may attempt to accelerate income into 2012 to avoid higher taxes in 2013, companies are making similar considerations. Goldman Sachs predicts that a record number of companies may pay special dividends in the fourth quarter to return cash to shareholders at 2012's low dividend tax rate.

Tax-free Investments: As tax rates increase, investments that produce tax free income or returns become more valuable. Tax-free municipal bonds may see increased interest and demand as a result. Consider that the taxable-equivalent yield of a 3 percent municipal bond is 4.62 percent at the 35 percent tax rate, but jumps to 5.3 percent if the top interest-income tax rate goes to 43.4 percent as scheduled.

Retirement Accounts: Contributions to tax-deferred accounts such as IRAs and 401(k)s made in 2013 may help shield income from higher tax rates. Plus, investors won't have to worry about higher taxes on dividends or interest income for assets that are located within tax-advantaged accounts.

Benjamin Franklin once said that nothing in this world is certain except death and taxes. Unfortunately, Franklin didn't mention anything about what rate of taxes must be paid. If the fiscal cliff and its attendant tax code changes have left you feeling uncertain, consider this a perfect opportunity to meet with trusted tax, trust, and investment professionals to discuss your unique circumstances. With a well considered plan in place, you may look back on the fiscal cliff someday as just a bump in the road as you work toward your goals.

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