The 2013 Fiscal Cliff

The goal of the MAInsights platform is to provide you with our views on the most pressing issues and opportunities in the current investment environment. In this light, the impending U.S. "fiscal cliff" in 2013 has emerged as a primary topic of debate among market participants and will continue to grow in importance as the election season draws near. In this brief discussion, we hope to shed some light on this critical issue and what it could mean for the markets.

How did we get to this point?

In a decade marked by two recessions and a major military effort in the Middle East, the U.S. government has run consistent budget deficits since 2002. Their heightened response to the 2008-2009 financial crisis caused the annual deficit to explode by a multiple of 7x; rising from $160 billion in 2007 (roughly 1.1% of real GDP) to $1.3 trillion in 2011 (approximately 8.5% of real GDP). The accumulation of these deficits over the past several years has vaulted total public U.S. debt levels to over $15 trillion (nearly 100% of real GDP) and on to an unsustainable trajectory by any measure. Up until now, the "kick the can down the road" strategy has appeased the market in hopes that the economy would eventually outgrow the debt; but with deficits of 8.5% of GDP per year and the overall economy mired in a 2% growth slump, we seem to be running out of road. Thus, the clock is ticking for our elected officials to come up with a credible solution to reduce the deficit and stabilize debt levels, while balancing the risk of cutting more than the economy can handle.

How big is the cliff?

On January 1, 2013, over a half-trillion dollars worth of tax cuts and federal spending will be removed from the economy if there is no action taken by U.S. politicians before the end of the year. Assuming all policies expire, the $537 billion fiscal cliff will subtract an estimated 3.5% from GDP in 2013 and will cause real personal disposable income to contract at a 10% annual rate in the first quarter. Among the policies in question, the Bush tax cuts on dividends, capital gains, and personal income (which together represent about $250 billion of annual stimulus) and the 2% payroll tax cut ($93 billion of annual stimulus) represent the highest impact programs. In addition, around $100 billion in spending sequesters related to last year's debt ceiling compromise and $26 billion in taxes associated with the Affordable Care Act of 2009 ("ObamaCare") are also set to be instituted. Altogether, the fiscal cliff would represent the largest form of tax increase on the U.S. economy since World War II and would almost certainly trigger a new recession.

What can be done?

Congress has until the end of the year to devise a plan to soften the impact of the fiscal cliff. In our opinion, the economic cost of doing nothing is too drastic in this case, thus Congress will likely arrive at an agreement in their December "lame duck" session which satisfies the credit rating agencies and buys them more time to deal with the problem. We would stress that while extending some current policies will help soften the blow, unlike in recent years, there will be no new federal stimulus in 2013. In fact, most economists believe that the best case scenario is a $150-200 billion federal drag next year (about 1-1.5% of GDP) due to the likely expiration of the payroll tax cut, caps on discretionary spending agreed to last summer, and the "ObamaCare" tax on investment income for upper income individuals. Putting that into context, the U.S. economy is growing at a run rate of just $300 billion per year, so a $150-$200 billion drag is still very significant.

What are the implications for the markets this year?

Regardless of the results of the November election and the lame duck session in Congress, we believe that the wide range of potential outcomes this winter will only fuel greater uncertainty in the economy for the remainder of the year. From our perspective, it is hard to blame CEOS for sitting on record amounts of cash when the cost of doing business is so up in the air, and we would expect them to continue to delay investment decisions until there is more clarity on taxes and regulation. In this light, we anticipate the elevated uncertainty to cause slower economic growth and a jittery equity market in the coming quarters and thus we are maintaining a slightly cautious stance at this time. A few themes we continue to emphasize in portfolios are energy master limited partnerships, dividend-paying equities, and emerging market equities and bonds, as we believe income generation and secular growth themes should demand a premium in today's highly volatile, low-growth environment.

Sources:

1. Federal Reserve Bank of St. Louis (FRED: GFDEBTN)

2. Strategas Research Partners, May 1, 2012

3. ISI, April 26 and May 8, 2012