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Note

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Fiscal Cliff

Since the election, "fiscal cliff" concerns have dominated the news and equity markets. Over the past several years, rather than resolving critical tax and entitlement legislation, it has been politically expedient to defer action, creating the prospect of this half trillion dollar austerity event Jan 1st. Time is short and major partisan political divides remain, creating uncertainty and widespread investor unease. Rather than assuming the worst, it's important during events such as this to examine the possibilities, two of which we can readily dismiss.

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Implausible possibility #1 is that our essentially identically divided, partisan political structure will come together for the good of the country to resolve this crisis in a civil, grownup manner. Instead, we need to expect rancorous, hardball negotiations and at best an 11th hour resolution. The other implausible possibility is that we run off the cliff and that's that. That amount of austerity would do wonders for our budget deficit problem, but the Congressional Budget Office estimates it would also destroy nearly 4% of 2013 GDP, which means certain Recession. Neither party wants any part of that proposition, which means the actual resolution will land somewhere between these extremes.

There is not enough time between now and the end of the year for politicians to negotiate the "grand bargain" Obama seeks. Assuming political progress is being made toward that objective, a one-year compromise could occur before Dec 31st, with negotiations for both tax and entitlement reform to follow in 2013. In this case, it is unlikely additional tax revenue will come from a tax rate hike, but instead from something like a deduction limit. According to the Tax Policy Centre, a $50,000 deduction limit would generate $750 billion over 10 years, so substantial revenue is available from this route. This is the scenario the market will most favor.

If insufficient political progress is being made, Obama's hardball option is to let the "cliff" event occur, thereby automatically raising tax rates Jan 1st. In fact, if tax rates are to rise, this may be the only viable route given the pledge of so many Republicans not to do so. At that point, tax rates can be negotiated back to current levels for all but the highest earners, thus allowing Republican politicians to maintain their pledges. If this scenario is wrapped up quickly in 2013, the adverse economic impact should be relatively modest, as legislation will be made retroactive to Jan 1st.

It's hard to imagine a long-term political impasse, given that the tax hikes and program cuts are expected to trim approximately 0.33 percentage points from GDP each month. In a matter of months, this would cause a self-induced Recession. There would simply be too much political pressure for this to occur.

Hopeful is the post-election tone of the key players, which is a reflection of an election result that pretty much everyone doesn't like in some respect. Assuming either of the more plausible scenarios above, expect the market to quickly recover whatever ground is lost once a resolution is achieved.

It is important that the "grand bargain" address our long-term budget deficit problem. Our debt level is too large to be sustainable, and continuing to federally spend so far in excess of our revenue will in time prove ruinous. And continuing to defer action is no longer viable either, so this needs to be the time and place to tackle this issue. Assuming this occurs, we will have captured an important silver-lining from this episode.