BULL AND BEAR BULLETIN

Dissecting the Fiscal Cliff

With the U.S. election results maintaining the status quo, both political parties will be forced to find common ground to prevent a loss of confidence among consumers and investors. The major concerns of Americans and investors alike are the pending tax increases, who will be squeezed by any tax hikes and how the government will handle the $1 trillion in sequestration cuts.

While President Obama and elected Democrats have made it clear they favor higher taxation on wealthier Americans as a means to address the pending Fiscal Cliff, the percentage of Americans expected to face higher marginal tax rates may be limited in scope. One of the first areas of compromise that Democrats and Republicans must resolve is the definition of "rich". The Democrats have mentioned $200,000 for individual tax filers and $250,000 for married couples filing a joint return, while the Republicans have been adamant that they oppose any marginal tax rate increases. In order to find compromise, it is likely that Republicans will have to eliminate their mandate and the Democrats will have to offer a much higher adjusted gross income level.

A second area that is important to consumers and investors is the way Congress will handle the FICA payroll tax break that is set to expire on December 31. Economists have estimated that the payroll tax break adds 0.6% to our economy's growth rate. With the economy growing just 2.0% in the last quarter, the year-end expiration could have a significant impact on our country's economic growth and the financial markets. Conversely, by allowing the FICA payroll tax break to expire, Congress would reduce the negative impact the lower FICA tax rate has on the Social Security Benefit Trust.

One of the most likely areas to see higher taxes in the coming year will be investor income. Qualified dividend and long-term capital gains rates are scheduled to increase as the Bush Era tax breaks expire. The long-term capital gains rate is scheduled to reset to a maximum rate of 20% from 15% and qualified dividends will be taxed at an investor's ordinary income rate. In an effort to help support the recent healthcare legislation, investors with an adjusted gross income exceeding $200,000 for single filers and $250,000 for married couples filing jointly will have an additional 3.8% surtax on investment income. The immediate impact of this legislation may be a rebalancing by investors away from dividend paying stocks and a renewed preference for either growth oriented stocks or tax exempt municipal bonds.

Perhaps the most exaggerated concern of the Fiscal Cliff is the immediate need to implement $1 trillion in spending cuts by January 2 as part of last year's failed deficit reduction process. While both political parties are likely to quarrel over the source of cuts, the budget reductions are to be implemented over a 10-year period. If the anticipated budget reductions average $100 billion annually, the spending cuts will only account for 0.7% of our nation's economic activity. The primary focus of any government spending cuts should be how each program is contributing to our nation's deficit. The major sources of our annual deficit are defense spending and entitlement programs. Barring any major adjustments in these significant programs, any benefits achieved from ancillary spending cuts will likely be surpassed in short order as more baby boomers reach retirement age.

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The greatest risk to the markets over the next six weeks is a divided Congress that adopts a "do-nothing" approach that allows the $607 billion in annual Bush Era tax cuts to expire, the Social Security payroll tax to reset to 6.2% and is forced to cut $1 trillion from the Congressional budget over the next 10 years. The combined impact of the forced spending cuts and tax increases could be reversed by retro-active policies in the 2013 Congressional session, but the impact on consumer and investor confidence would be devastating to the economy and financial markets.

While very unlikely to occur, the best case scenario incorporates a "grand bargain" that involves both entitlement and tax reform. A "grand bargain" would clearly improve consumer and investor confidence and would result in significant gains for both the economy and financial markets. Unfortunately, with an election that displayed a nation divided, neither party seems open to such a wide-sweeping policy and call to action.

Our belief is that the financial markets have already factored in the most likely course of action by Congress, a short term solution to the Fiscal Cliff that will incorporate some minor spending cuts, higher capital gains and dividend tax rates and a limited increase in the marginal income tax rates. While lacking any major policy shift, a minor compromise may be sufficient to prevent a collapse in confidence and a further market correction. The downside to a short term solution is that it will fail to boost business confidence and promote further employment gains. The postponement is only likely to prolong the existing "Muddle Through Economy" and to result in additional market volatility.

President Obama has proposed maintaining the lowest four tax rates and brackets that were created by the "Bush tax cuts", but would like to increase the rates on the top two tax brackets (see table below).

Current Rate - 2012	*President Obama's Proposed 2013 Tax Rates*
10%	10%
15%	15%
25%	25%
28%	28%
33%	36%
35%	39.6%
	+3.8% on investment income * +0.9% on high income *

*Rates enacted in the 2010 Healthcare legislation. The additional Medicare tax applies to wages and self-employment income over the applicable threshold - $200,000 for unmarried individuals, $250,000 for married filing joint, and $125,000 for married filing separate. The Medicare contribution tax applies to the lesser of (1) net investment income or (2) modified adjusted gross income (MAGI) over the applicable threshold - $200,000 for unmarried individuals, $250.000 for married filing joint, and $125,000 for married filing separate.