Quadrant
ASSET MANAGEMENT

QAM Update
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The QAM letter that highlights recent developments that we think either affect the markets or are important to understanding them.

“You can always count on Americans to do the right thing – after they’ve tried everything else!” – Winston Churchill

Here comes the cliff

To the objective eye, it looks like the markets can worry about one, and only one, thing at a time. Following the news from the media, it seems that the market just changed the music they dance to. It was European Style up to a few weeks ago, now it is Washington Style. Maybe the latest iTunes and YouTube chart topper, Gangnam Style is next.

The risk on / risk off days changed from being European Debt Crisis driven to “Fiscal Cliff” driven. When the markets participants collectively feel that an agreement is reached, stock markets are up. When no agreement is in sight, stock markets are down. Fundamentals? Looks like nobody checked lately but very good, thank you.

So, what is this so called Fiscal Cliff?

According to the Huffington Post: *“The term "fiscal cliff" is a one-sided propaganda phrase that misinforms and triggers public fear and anxiety. The fiscal cliff is not a "cliff" and the country isn't going to fall off anything at the end of the year.”* We are inclined to agree.

In his testimony before the Committee on Financial Services of the U.S. House of Representatives in February 2012, Federal Reserve Chairman Ben Bernanke warned about “a massive fiscal cliff of large spending cuts and tax increases”, and suggested Congress should “figure out ways to achieve the same long-run fiscal improvements without having it all happen at once”. The tone and intent of Bernanke’s comments were not to warn of impending doom, but to chide the members of government to stop playing politics and actually govern. The press and the politicians, each for their own reasons, choose to interpret the comments as a promise of impending economic doom. Thus the term “Fiscal Cliff ” was born.

The large spending cuts and tax increases that Bernanke referred to were entrenched in the Budget Control Act of 2011. This act was the “compromise” reached between the Democrats and Republicans in order to raise the debt ceiling. The act called for a Joint Select Committee on Deficit Reduction (“Super Committee”) to develop and submit a plan to Congress to reduce the budget deficit. If the Super Committee failed (which it did), embedded tax increases and spending cuts would commence on January 2, 2013.

The main events that make up the “Fiscal Cliff” on the Tax Revenue side are:

1. Expiration of the 2001/2003/2010 Tax Cuts:

- Broad increase in income tax rates of between 3% and 4.6%; elimination of 10% bracket
- Increase in capital gains taxation rates
- Increase in dividend taxation rates

2. The End of Alternative Minimum Taxes relief: estimated 25 million tax payers no longer exempt from AMT.
3. The end of 2011 Payroll Tax Cuts; employee payroll taxes to increase from 4.2 percent to 6.2 percent.
4. The expiration of various “Tax Extenders”: mainly Research and Experimentation Tax credits.
5. The implementation of new taxes from the Patient Protection and Affordable Care Act. The largest of these measures is a 0.9 percent increase in the Medicare Hospital Insurance payroll tax for higher earners and an effective 3.8 percent tax increase on investment income.

The main events that make up the “Fiscal Cliff” on the Spending side are:

1. Mandatory Budget Cuts: Activation of the Sequester representing an across-the-board $1.2 trillion spending cut over ten years as a result of the failure of the Super Committee. Defense spending to be cut across the board by about ten percent and non-defense discretionary spending cut by about eight percent.
2. End of Extended Unemployment Benefits: reduces the number of weeks individuals can collect unemployment insurance.

Estimates of the impact of all these events combined on the budget vary from 3.3% of GDP to 5% of GDP depending on what is considered “cliff policies” versus “baseline policies”. This translates into US$ 500 billion to US$ 750 billion of deficit reduction per year.

As it often happens, experts cannot agree on the level of impact of the “Fiscal Cliff” on the economy. They do agree, however, that the economy would take a serious hit and risk entering a recession if no action is taken. The economic impact estimate varies from 2.2% to 7% of GDP depending again on what policies are considered and also on what multiplier is used (a relatively more complex economic metric that represents how much the economy expands or contracts for each dollar of budget increase or reduction).

All these estimates are “if nothing is done” scenarios. At this point, almost everybody agrees that the US economy needs to address its fiscal deficit, but in a more comprehensive and gradual way as opposed to falling off a cliff. On the other hand, extending the “cliff policies” forever would clearly add to market uncertainty (and lead to a fiscal crisis).

Most analysts expect some agreement that would include extending some of the “cliff policies”, reducing corporate tax rates (that would benefit corporate spending) and seeing an increase in tax

rates for individuals in the high income tax brackets. The right combination could be beneficial for the long-term health of the economy and would convert a potential crisis into an opportunity.

It is impossible to know what will happen in the short run with any certainty. The worst case scenario is not something we consider likely, as the political cost for any party allowing it would be too much to bear. But if only some of the negative effects of the fiscal cliff materialize, and the economy does enter into a recession, the stock market will inevitably feel the pain. We wouldn't expect this to be a long lived slump as fiscal policies will be implemented (in a reactive way) and new Fed policies will add monetary stimulus to the QE3 already in place.

Benjamin Graham wrote in his classic investment book, "Security Analysis", that in the short-term the stock market behaves like a voting machine, but in the long-term it acts like a weighing machine (true value emerges into prices in the long-run).

At QAM we see more value for the long-term investor in stocks and real assets that better hedge inflation than in fixed-income instruments or cash. Timing the market (even due to political events) fails more often than not. The short-term could catch us dancing to the wrong tune, but keeping our long-term objectives front of mind will be a better way to find us doing the happy dance in the end.

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