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A Slope Not A Cliff: Most Tax Cuts Likely To Be Extended

We continue to believe that most of the fiscal cliff's impact will be avoided next year. We had hoped for a deal before year end, which would have lessened economic and investment uncertainty. However, a trip over the cliff looks increasingly likely and thus, taxes rates will increase before congress acts. Republicans seem to believe the appearance of lowering most Americans' taxes after they go up, rather than raising taxes on a small percentage of high-income earners, will provide the political cover necessary to allow a compromise with the Democrats. We think there is little difference in the outcome except for a near-term loss of confidence (and an even lower opinion of congress). The fiscal cliff is actually more of a slope, with the spending cuts and tax increases taking effect incrementally over time. If the fiscal cliff is resolved in the first few weeks of 2013, its economic impact should be minimal.

Our 2013 baseline scenario – modest economic growth and extraordinary monetary accommodation – remains unchanged. Given ongoing political intransigence, the risk of recession may be slightly higher in the short-term, but we think it should fall by early next year. Moreover, while US fiscal policy is still a mess, fiscal policy is beginning to improve internationally. Europe has already made painful cuts to stabilize its deficits, while Japan's newly elected leadership is expected to enact long-needed structural reform and growth measures intended to whittle away its debts. In other words, the rest of the world is much further along the budget-cutting austerity process than the US, where it has yet to begin. Since last summer we have reduced our US portfolio exposure and raised weightings in Europe, Japan and selective emerging markets. We believe this will insulate our portfolios from near-term fiscal cliff uncertainty while increasing our exposure to attractively valued parts of the world that are showing initial improvements after years of underperformance. We expect the S&P 500 to be up in 2013, but at a more modest pace than this year's 13.7% year-to-date price gain.

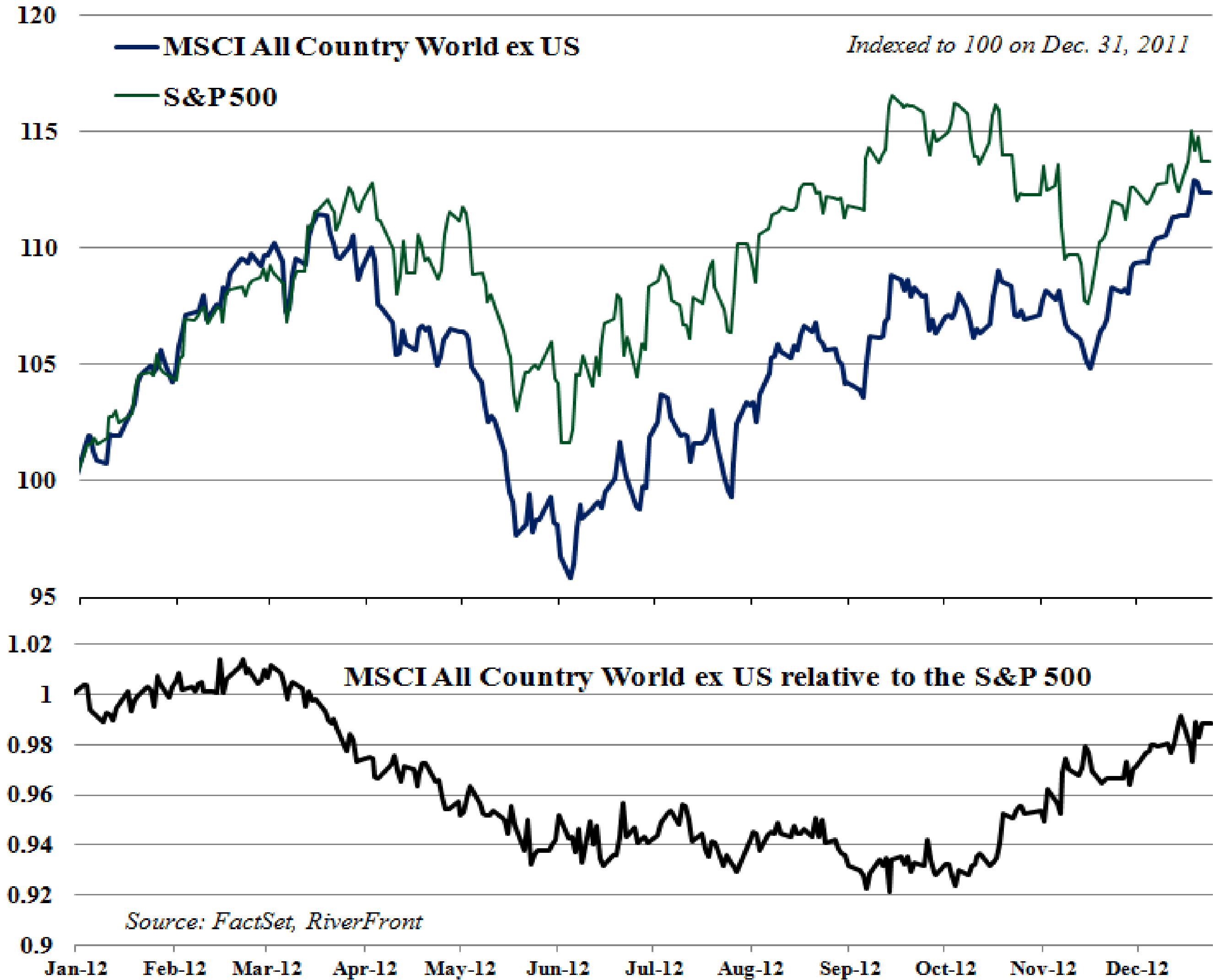
Although we do not think it makes sense to go over the fiscal cliff, the failure of House Speaker John Boehner's 'Plan B' indicates that a majority of Republicans refuses to vote for any tax increase. It should be easier for ideologically tax-averse Republicans to vote for a deal after the January 1st expiration of the Bush tax cuts. Once taxes have gone up, negotiations will be about tax cuts rather than tax increases. Alternatively, any last-minute compromise that Boehner reaches with the President could pass the House, as Democratic support would overwhelm Republican opposition.

President Obama's negotiating leverage is rising along with his approval rating, while the Republicans appear to be in disarray after the failure of Speaker Boehner's plan. Thus, whether a deal is struck before year end or not, the resulting tax increases are likely to take effect at a lower income level than the $1 million proposed under Plan B. However, if House Republicans do not agree to a new deal then taxes go up on everyone, an outcome that is anathema to Republican economic ideology and could

prove costly in the 2014 elections.

Hence, instead of the economy going over a cliff, the economic impact of the current budget impasse is likely to be more like a slope whose steepness will be determined by the amount of retroactive tax cuts enacted in 2013. Given the initial negotiations and the strongly stated positions of many Senate Democrats from high income states, we believe that the lower Bush tax rates are likely to continue for US household with incomes under $500,000.

THE WEEKLY CHART: FOREIGN STOCKS OUTPERFORMING US SINCE OCTOBER



Foreign stocks, as measured by MSCI's All Country World Index excluding the US, have begun a trend of outperformance that we expect to continue in 2013. This outperformance can be seen in the bottom panel of our chart (when the line is rising, foreign stocks are outperforming the S&P 500). We think this outperformance can extend into 2013 because the rest of the world is much further along the budget-cutting austerity process than the US, where it has yet to begin.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. Technical analysis is based on the study of historical price movements and past trend patterns. There are also no assurances that movements or trends can or will be duplicated in the future. Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. The MSCI All Country World Index ex the US Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets excluding the US.