The Fiscal Cliff That Isn't?

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The Fiscal Cliff—A Significant Recession Risk in 2013...

As 2012 winds down we're trying to think ahead to 2013. When we assess the economic outlook there is nothing that poses a bigger risk to US economic growth than the fiscal cliff. The fiscal cliff is the potential reduction in almost $600B in total federal spending or about 3.8% of GDP. This is a substantial decline and would amount to a sharp move towards the austerity camp in the USA.

Those of you who are familiar with our position know that we've been working under the theory of the Balance Sheet Recession for many years now. That is, the private sector is undergoing a de-leveraging due to the collapse of the debt bubble. This results in depressed private sector spending and as output goes unsold, layoffs increase and you risk a snowball effect wherein the private sector enters a depression as it can't sustain sufficient spending on its own. This is essentially what's currently occurring in several European nations.

Although the US households have made substantial improvements in their balance sheets the private sector is still not growing at a sufficient rate for the government to pull in the spending at such an accelerated rate. We are certain that a worst case scenario in the fiscal cliff outcomes would result in US recession, a substantial decline in corporate profits and much lower equity prices. Therefore, it's important to obtain a better understanding of this enormous risk.

The Fiscal Cliff Math

Total potential cuts & expiration of current policies could amount to a total of $580B. This is a total of 3.5% of GDP. But we don't

believe that this entire amount will be cut from the 2013 budget.

The largest chunk of the potential cuts would come from the Bush Tax Cuts which total roughly $180B in tax increases. There is broad consensus that the middle class cuts will remain and the Republicans are likely to bargain intensely for the upper class cuts to remain. We believe any deal will involve a complete continuation of this portion of the "cliff".

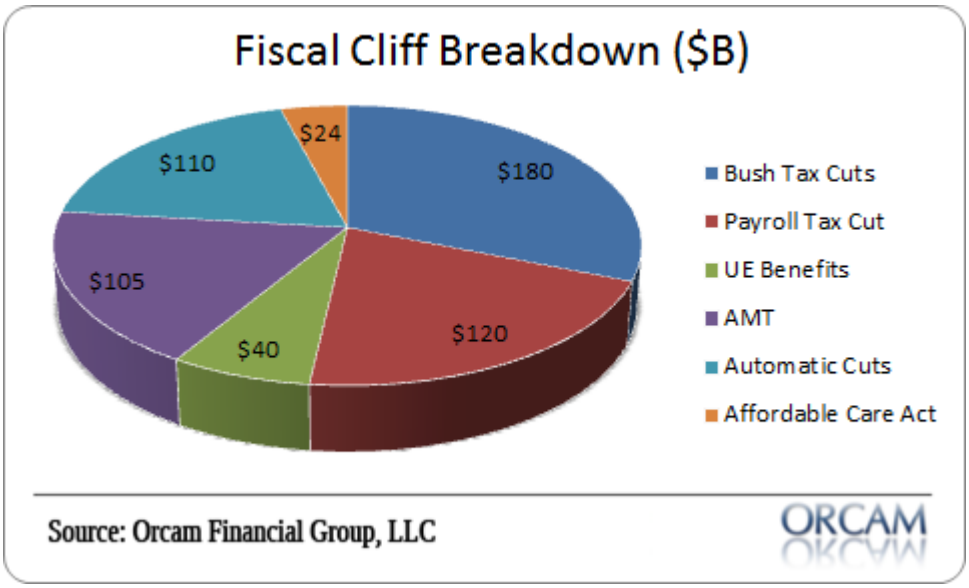
The second largest piece is $160B in the 2009 stimulus bill which led to the 2% payroll tax cut as well as the extension of unemployment benefits. There are likely to be at least partial cuts here. The Republicans have fought intensely against an extension of the unemployment benefits, but the Democrats will have more leverage extending the tax cuts as they did last year. This means there is the potential for a $40B cut from this piece of the "cliff" pie.

The Alternative Minimum Tax cut would add $105B to the cliff, but this is highly unlikely to get cut from the budget.

There are $110B in cuts expected from "automatic spending cuts" which include large defense cuts. The President was very adamant in Monday's debate that he would not allow these cuts to go through. There appears to be some consensus that neither side wants to allow these cuts to be made, but there is likely to be a battle here ending in some sort of compromise. We estimate the cuts will likely not amount to anything over $30B in total.

The last piece of the pie is the Affordable Care Act Tax which is certain to go through. This amounts to a total of $24B.

If the cuts are close to what we estimate we are looking at something in the range of about $100B. Obviously, there's some guesswork in there since it's impossible to know what US politicians will do in these times of persistent disagreement, but the odds seem to point towards less cuts and not more.



All in all, this isn't a terrible outcome. $100B is roughly 0.5% of GDP. That's not insignificant for an economy that's growing at less than 2% at present. But it could be a lot worse. We'll keep you updated as time goes on, but we believe there are two great uncertainties overhanging the market at present: 1) the outcome of the election; and 2) the fiscal cliff. Resolution of both will likely alleviate some of the recent fears in the markets. Obviously, the election will be settled by the first week of November and the fiscal cliff should be settled by the middle of December.

We'll keep you updated….

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