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"Cliffhanger on the Way"

Is the stage set for a "fiscal cliffhanger" in Washington?

Most of us can recall the 1993 thriller "Cliffhanger" starring Sylvester Stallone and John Lithgow. The movie was about a botched mid-air heist resulting in three suitcases full of cash ($100 million to be exact) being scattered high in the Rocky Mountains and the suspenseful search and rescue that ensued. Well at the end of this year, Washington is facing its own cliffhanger and the American people are anxiously waiting to see how the action thriller will end. This time $1.2 trillion could be at stake.

Many economists believe that potentially higher taxes combined with the federal spending cuts slated to begin next year could push the economy over the so-called "fiscal cliff" in 2013. I thought it would be helpful to shed some light of the upcoming policy changes that may impact your portfolios as well as the potential outcomes.

As we move closer to the US presidential election and the end of 2012, we are hearing more about the devastation that the so-called "fiscal cliff" will have on the US economy. I want to really look at what is at stake here.

The **fiscal cliff** refers to $600 billion in tax increases and spending cuts that will occur on January 1, 2013, should Congress not extend what have become known as the Bush administration tax cuts that were put in place in 2001 and 2003 and the payroll tax cut that has been in place for the past two years. The spending cuts come from the sequester, which I will explain, and the expiration of unemployment benefits.

The **sequester** pertains to the $109 billion per year in cuts set to take effect at the beginning of 2013 because the deficit reduction "super committee" failed to achieve $1.2 trillion in savings. Those savings were agreed to when Congress raised the debt ceiling last year.

The **debt ceiling** is the legal cap on the amount of debt the US Department of the Treasury can issue. It currently stands at $16.4 trillion. The United States is likely to hit this debt ceiling in the first quarter of 2013. If Congress does not act to raise the debt ceiling, the federal government will no longer be able to borrow to fund its deficit, forcing a drastic reduction in expenditures that could affect everything from Social Security payments to federal grants. If you recall, the last Debt Ceiling debate in congress was more reminiscing of another Stallone movie – "Rocky".

All of this would amount to a huge logjam for the US economy. Right now the economy is growing at a rate of approx. 1.6%. If all the tax increases and spending cuts take effect, we will likely see the gross domestic product (GDP) contract by around 3.6%, which would mean the US economy would be in recession.

Possible outcomes

Obama wins and Democrats take control of Congress

Given the political divisions between congressional Republicans and Democrats, I do not expect to see a deal on any of the fiscal issues before the elections on November 6. Americans will elect a president, one-third of the Senate and the entire House of Representatives. Given the possible changes, investors should keep an eye on this election. If Barack Obama is reelected and Democrats gain the majority in Congress, then it is likely that taxes will be increased. However, I expect that taxes on dividends and capital gains (both now at 15%) may be raised but not to the levels they were before the Bush tax cuts. It is also likely that the payroll tax will be reinstated and that the sequester will not occur. However, it is very unlikely that the Democrats will win the House.

Republicans take control

If the Republicans win control of the White House and Congress, then the tax cuts now in place will be continued for several years and the sequester will not take place as planned. The cuts may, however, be stretched out over time. In that case, the economy would probably suffer, but recession would likely be averted.

If Washington does not agree on a solution, the economy, which is now growing slowly and in the middle of its business cycle, could tip into recession. We would then see the full effect of the tax and spending cuts take hold. The resultant slowdown in the United States could have negative effects on economies in emerging markets and Europe and could in effect create another global economic crisis.

What is likely to happen?

I do not think it is in anyone's interest to trigger economic failure. I believe that politicians in Washington are aware of the fragile economic environment. They will likely put together enough emergency legislation to delay, postpone, and defer the crisis, leaving another Congress to deal with the issue. ***I do not believe they will allow a lethal combination of tax increases and government cutbacks to occur all at once***. It appears that there is room for a compromise - to increase taxes on top earners while raising taxes, but not as drastically, on the middle class.

Furthermore, the taxes for health care and unemployment benefits could be modified and staggered to allow the economy and the business cycle to heal. In that event, the business cycle would continue, and neither corporate profits nor equity valuations should be impaired.

And then this crisis will be forgotten as was the debt ceiling crisis of last summer. It appears the markets may be already discounting a compromise as the markets continue to rally. As always, do not hesitate to give me a call to discuss any questions or concerns that you may have.

"Life's not about how hard of a hit you can give... it's about how many you can take, and still keep moving forward."

Rocky Balboa

Sincerely,

Preston

J. Preston Byers CPA CFP®
President

pbyers@clearbridgewealth.com

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PROFESSIONAL
2011 Wealth Manager

7000 Central Parkway Suite 1760 l Atlanta, GA 30328 l 770-350-9605