INVESTMENT STRATEGY COMMENTARY

THE FISCAL CLIFF: NOW FOR THE HARD PART

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Tuesday evening the U.S. House of Representatives passed the American Taxpayer Relief Act (ATRA), addressing the tax portion of the fiscal cliff, but delaying decisions on the spending part for another two months (for now). This delayed deadline now has the debate on spending coinciding with the deadline to increase the U.S. debt ceiling. The ATRA's accomplishments include extending the 2012 income tax rates for low- and middle-income taxpayers, and limiting the increase on capital gains and dividends. Left unaddressed are questions related to spending – the scheduled cuts to defense and discretionary spending have been deferred by two months, and the ATRA does nothing to address long-term entitlement spending problems. The financial markets' focus in coming months will be split between two competing sights: a gradually improving global economy and a potentially raucous debate in the U.S. over entitlement reform and the debt ceiling. While we expect market volatility to remain elevated during the next several months, we believe the combination of moderate growth and easy monetary policy will carry the day and that portfolios should continue to be positioned for growth through tactically overweighting equities and natural resources, and underweighting investment grade bonds.

EXHIBIT 1: WHAT WAS AGREED?

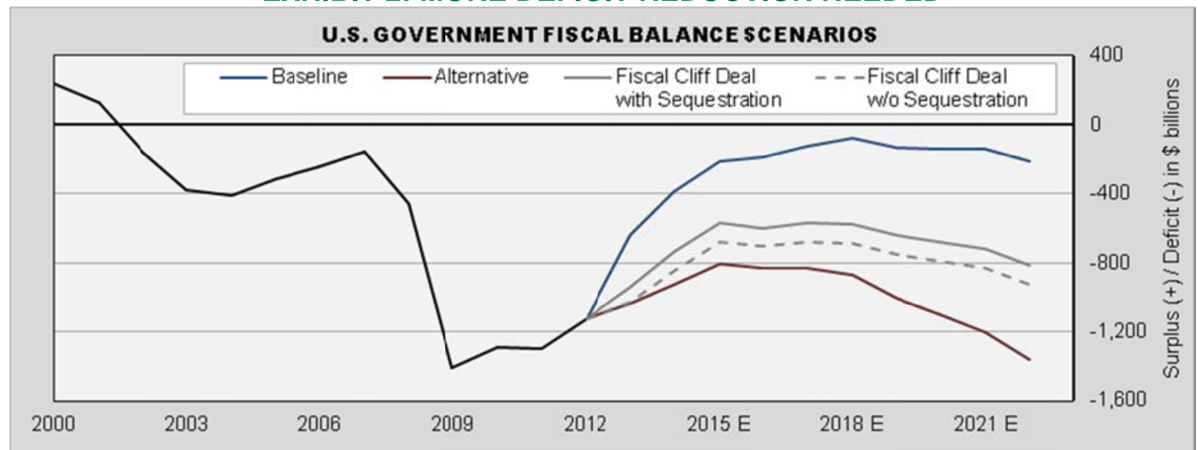
COMPONENTS OF FISCAL CLIFF AGREEMENT		
Tax Legislation		
Item	2012 Law	2013 Law (ATRA)
Ordinary Income Tax Rates	10%, 15%, 25%, 28%, 33%, 35%	Additional 39.6% tax-bracket for incomes >$400k ($450k if married, filing jointly)
Qualified Dividends/ Long-Term Capital Gains	0%, 15% for those in higher tax brackets	Additional 20% level for those earning >$400k ($450k if married, filing jointly)
Medicare Tax on Net Investment Income	None	3.8% for modified adjusted gross incomes >$200k ($250k if married, filing jointly)
Alternative Minimum Tax Threshold	Various	Retroactive increase for 2012; indexed to inflation going forward
Social Security Payroll Tax Relief	2% reduction (employees: 4.2% vs. 6.2%; self-employed: 10.4% vs. 12.4%)	Reduction expires
Itemized Deductions/ Personal Exemptions	No additional high-income taxpayer phase-out	Phase-out of personal exemptions and up to 80% of itemized deductions for incomes >$250k ($300k if married, filing jointly)
Estate Tax	35% for estates larger than $5,120,000	40% for estates larger than $5 million; adjusted for inflation
Spending Components		
Sequester	Two month delay	
Unemployment Insurance	One year extension	
Physician Medicare Reimbursement Cuts	One year delay	

Source: Northern Trust Tax Strategy Group, Northern Trust Investment Strategy.

Economic policy uncertainty has been elevated over the last several years, and the arrival of the fiscal cliff presented an opportunity to add some clarity. On the tax front, important progress was made in permanently extending the Bush-era income tax rates for lower and middle-income taxpayers, while providing certainty around the tax rates on higher-income taxpayers. With respect to investment-related taxes, there was no change to the tax treatment of tax-exempt municipal bonds and qualified dividends and capital gains tax rates rose from 15% to 20% for high-income taxpayers (before the 3.8% Affordable Care Act tax). Both of these are market friendly as there was building concern around the tax treatment of municipal bond income, and uncertainty around how large the increase on dividends and capital gains could be. The top gift, estate and generation-skipping transfer tax rates have permanently increased to 40%, with representative exclusions and exemptions set at $5 million adjusted for inflation. At the end of the day, the finality of the tax negotiations is a constructive step in removing some of the economic uncertainty hanging over the U.S. economy. From a growth standpoint, the permanent extension of the middle-class tax cuts eliminates the largest potential fiscal drag issue. Resumption of the full Social Security payroll tax collection and increased taxes on higher-income taxpayers will represent an approximate 1% fiscal drag in 2013, and implementation of the automatic spending cuts under the Budget Control Act of 2011 (sequestration) would represent further drag of around 0.8% of GDP. Growth will be affected in the first half of the year, but in a more manageable way than if no agreement on taxes had been reached.

Left unaddressed, however, is longer-term spending reductions. The mismatch between U.S. revenue (taxes) and spending is unsustainable at current levels, even before the upcoming increase in entitlement spending. Revenue has fluctuated between 16% and 21% of GDP throughout the last 22 years, while spending has represented between 18% and 25% of GDP. In 2012, the Congressional Budget Office (CBO) estimates revenue of 15.7% of GDP, spending of 22.9%, and a resulting deficit of 7.2%. The U.S. can likely sustain a long-term fiscal deficit of 2% to 3%, meaning we need a 5% reduction from current levels. Federal budget accounting is a complicated matter, and in Exhibit 2 we present some alternative deficit scenarios.

EXHIBIT 2: MORE DEFICIT REDUCTION NEEDED



Source: Northern Trust, Congressional Budget Office; estimates begin in 2013.

Note: Baseline assumed all fiscal cliff provisions would be enacted as scheduled. Alternative scenario assumed expiring tax provisions (other than payroll taxes) would be extended and automatic spending cuts did not occur.

The CBO Baseline scenario, with the lowest deficits, assumes that the laws in place in 2012 continued through the study period – meaning that the Bush-era tax cuts expired and the spending sequestration occurred. Their Alternative scenario, presented to represent a more realistic outcome, assumed extension of much of 2012 policies – including continuing low tax rates and no sequestration. The deterioration in deficits over the time frame is due to increases in entitlement spending – including Social Security, Medicare and Medicaid. Mandatory spending is projected to climb from 13.4% of GDP in 2013 to 14.3% in 2022, while discretionary spending is expected to decline to 5.6% of GDP by 2022 – the lowest level in 50 years. To the mix we have added two computations based on the passage of the ATRA – one assuming the sequestration (based on CBO calculations) and one without it. The latter scenario is useful to isolate what was actually agreed to in the ATRA. Looking out to 2015, the ATRA deal, without sequestration, would still leave a deficit of around $675 billion, approximately 3.8% of GDP, which would then deteriorate through 2022. These various scenarios highlight the necessity of long-term entitlement reform, and why the negotiations over the next two months will be so heated.

CONCLUSION

Passage of the ATRA is a short-term positive for the markets as it provides some needed clarity and finality on tax rates for 2013. The rate increases on higher-income taxpayers were not a surprise, and the broad package of investment and wealth transfer related provisions was generally constructive. Higher-income holders of income-generating investments, such as dividend-paying stocks and municipal bonds, have avoided the potential of much larger tax bills, which should support both of these asset classes. Unfortunately, many of the difficult decisions around spending were deferred for at least another two months and will coincide with the need to raise the U.S. debt ceiling and the expiration of the continuing resolution funding the government. With Democratic and Republican leaders already posturing for these negotiations, we do not expect this to be a smooth process. While this will likely lead to heightened market volatility throughout this period, we expect financial market turbulence to be fairly contained – and we continue to recommend a tactical overweight to risk assets.

Special thanks go to Suzanne Shier, director of wealth planning and tax strategy, for tax policy insights.

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