THOUGHTS ON THE FISCAL CLIFF
WITH CHIEF INVESTMENT OFFICER AL BHATT NOVEMBER 2012

HOSTED BY MANAGING DIRECTOR, CHIEF WEALTH OFFICER JOHN HARRIS

Now that the elections are (finally) over; markets have clearly put a critical lens on the impending "Fiscal Cliff" confronting the US and world markets more broadly. US equity markets are off almost 5% since the day after the elections, and prognosticators are busy assessing potential political outcomes from Washington DC. While we don't profess to have a Crystal Ball, we would like to outline the main issues of the Fiscal Cliff and its implications for portfolio management.

John Harris ("JH"): The Fiscal Cliff is clearly a major headwind to US GDP growth: it represents almost a $700 billion negative impact to GDP growth due to the resulting tax increases and spending cuts, nearly a 4% impact. Al, where do we stand regarding the Investment Committee's current thinking regarding the Fiscal Cliff and potential GDP detraction arising from it?

Al Bhatt ("AB"): As we mentioned in our Q3 Letter, we believe that the elections will likely lead to a lame duck session of Congress "kicking the can down the road" to March 2013 when the $16 trillion debt ceiling must also be re-addressed. In this scenario, we would expect that some of the Fiscal Cliff headwinds will be realized as we enter into the year 2013. Specifically, we expect that Congress may allow for the expiration of the employee payroll tax cuts and not extend unemployment benefits (a combined $160 billion potential hit to GDP). This may lead to an approximate 1% fiscal drag to GDP growth over the year.

JH: Will any components of the Fiscal Cliff be resolved by the lame duck session or will the balance of the 3% potential drag all be pushed well into the Q1 2013 time period?

AB: In a "positive scenario," one could argue that approximately 25% of the Fiscal Cliff is very likely to be taken off the table by Congress. These components could likely include the required Alternative Minimum Tax threshold adjustments, Special Interest Tax provisions (including credits for alternative fuels, tax credits for R&D and deductions for state and local taxes for example) and the extension on limits of Medicare spending for physician services.

JH: Given the above, it seems that there still remains almost 2% of the potential Fiscal Cliff to be addressed by the lame duck session or by Congress during Q1 2013, if your "kick the can down the road" scenario is accurate. What are these components?

AB: John, this is where we expect the most uncertainty regarding both timeline and outcome. Within this remaining portion of Fiscal Cliff headwind are perhaps the most contentious topics of legislative debate:

- Bush Tax Cuts ($280 billion impact and approximately 1.2% GDP drag)
- Sequestration ($100 billion impact and approximately 0.7% GDP drag)
- Obamacare 3.8% Tax Increase ($20 billion and approximately 0.1% GDP drag)

Within the above mentioned Bush Tax Cuts line item there are the following implications:

- Top marginal income tax rate increases from 35% to 39.6%
- Tax on dividends now at 15% will be set to marginal income tax rate
- Capital gains tax increases from 15% to 20%.

Sequestration is the series of forced spending cuts that were a result of legislation last year that raised the federal debt ceiling. These were put into place in the event that the Congressional "Super Committee" couldn't agree on a specific debt-cutting plan. Given that the temporary panel was anything other than "Super," it did fail to reach an agreed upon budget deficit solution. As a result, automatic spending cuts totaling approximately $1.2 trillion over 10 years from planned spending, including more than $500 billion from defense, will commence in the year 2013.

JH: Now that we have discussed the components of the Fiscal Cliff and a potential "kick the can down the road" scenario, can you outline the portfolio implications?

AB: First, it is important to stress that we are not going to make material changes to asset allocation based upon uncertain political outcomes. Having said that, we are always analyzing potential macroeconomic drivers and their implications for realizing attractive risk-adjusted returns across asset classes and strategies. The uncertainties surrounding the Fiscal Cliff in terms of timeline, magnitude of resolutions (or lack thereof) and its resulting implications further our cautious portfolio posture. We re-affirm the current asset allocation within our Balanced Model.

As we stated in our recent Q3 Letter, we do not believe that equity markets fully price in a Fiscal Cliff-induced recession, and to the extent the US does in fact "go over the Cliff," there could be meaningful downside risk in US equity markets. Equity markets are expected to remain volatile in this near to medium term period. However, at the same time, there have been slight rays of hope given the initial, post-election verbiage coming from Washington, DC, so there always remains the possibility for a "Grand Bargain." In this scenario there is little, if any, material GDP detraction. Again, however, the timing and mechanisms for such a Grand Bargain are not clear to us; moreover, by pushing the negotiations fully into Q 1 2013, Congress must also confront the $16 trillion debt ceiling issue at the same time. Hence, continued policy uncertainty will only serve to further mute business confidence and spending. This, in turn, dampens already muted expected GDP growth and provides little support for an improved employment environment. As a result, we fully expect that the Federal Reserve and Chairman Bernanke will retain their highly accommodative stance, and the low to zero interest rate environment will remain intact for some time.