Lassus Wherley ...a view from the top
Building Better Futures
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There are no words................

I was working on fine-tuning this newsletter on Friday, discussing the fiscal cliff and other questions, when the news of the shootings in Newtown, Connecticut came in. There are no words to express the feelings we experienced as we watched this horrible story unfold. We went from shock to horror to totally heartbroken as we learned of the lives cut short by such a brutal act. Our thoughts and prayers go out to the families who lost loved ones and to the first responders and officers who witnessed such a tragic scene.

Looking Forward to 2013…..

It has been difficult to move from thinking about the families in Newtown to thinking about next year and the challenges we face. But we all have to begin to move forward one day at a time.

Several weeks ago we decided to provide an update to address the issue which has been occupying Wall Street and all the financial news for the past few months, i.e., the "fiscal cliff."

The term "fiscal cliff" refers to the dramatic increases in tax rates and cuts in spending which are due to take place at year-end without any changes in current legislation. At the end of 2012, the Bush tax cuts, the temporary payroll tax cut and extended unemployment benefits will expire just as higher Medicare taxes and both rounds of cuts to discretionary spending agreed to last August begin to take effect. Neither the tax-cut expirations nor the sequestration spending cuts would happen all at once, but would be spread out over the course of the year 2013. For this reason, a better name for this scenario would be the "fiscal slope."

What is sequestration? It is a fiscal policy procedure adopted by Congress to deal with the federal budget deficit. It first appeared in the Gramm-Rudman-Hollings Deficit Reduction Act of 1985. In basic terms sequestration is the cancellation of budgetary resources or an "automatic" form of spending cuts. These automatic spending cuts can only be avoided if Congress passes legislation that eliminates the legal requirement and that President Obama signs before January 2, 2013.

We all recognize that the current level of borrowing at the federal level is unsustainable. The US government has been spending more than it has been generating in revenue for some time, which has resulted in a federal budget deficit. In order to balance the budget, cuts will need to occur across the board with significant reductions in spending. Balancing the budget will also involve increases in revenue. Differences in political views make this difficult, however, as Republicans are hesitant to increase taxes while Democrats are hesitant to decrease spending.

Whatever you call it, if our policymakers in Washington are unable to reach any sort of a compromise by year-end, a recession will probably result and stocks will adjust downward to this new reality.

As noted by former vice chair of the Fed,

Alice Rivlin, "We need to get our political house in order, make a decision about the fiscal cliff and stabilize the debt." It is apparent to all of us that the biggest problem we face right now is the partisan gridlock in Washington. This polarization is preventing policymakers from doing what they need to do.

In our opinion, it is most likely that the economy will not be driven off the "fiscal cliff." Odds favor a deal but this is probably going to be a small one. This seems most likely as the two parties have been far apart on three items: 1) tax rates for upper income individuals; 2) entitlements; and 3) President Obama's desire to have the ability to unilaterally increase the debt ceiling.

There is hope since House Speaker Boehner's most recent proposal includes an increase in tax rates for those with income over 1 million as well as a debt ceiling increase. In return, Boehner's proposal calls for at least $1 trillion in cuts from entitlement programs.

At this point, we don't see a complete overhaul of tax and spending legislation taking place this year, but even a smaller deal will be better than none. This will enable the economy to avoid the worst impact of all the tax increases and spending cuts. In a small deal, only some of the Bush-era tax cuts will be allowed to expire, the AMT will not be significantly broadened and there will be delays or deals made on the required spending cuts. These will be offset by the drag which will come from higher rates on upper income individuals and from the expansion of the payroll tax and the new Medicare tax on unearned income. The overall impact could amount to a drag of between 1% and 2% of GDP. This would be far better than the 4% fiscal drag which would occur if all of the tax hikes and spending cuts slated to take effect at year-end were allowed to do so, but would still represent a head wind for the economy in the form of less disposable income and cuts to government spending.

Such a deal can hopefully be arrived at before year-end. This legislation would likely be passed in conjunction with a promise that subsequent legislation would be enacted in 2013 to meet some of the longer term budget goals. In other words, we would once again kick the solving of some of the problems down the road.

The announcement that a deal has been reached will probably result in a relief, or "risk-on" rally. Such a rally might be short-lived, however, as it appears that investors are expecting a deal to be reached. Earnings estimates are not being revised downward and the VIX, the "fear gauge", is not going up very much at this point. So, if investors don't believe that the economy is about to go over the fiscal cliff, then the prospects for a big rally when a deal is announced is somewhat diminished.

While a small deal might be the most likely scenario, the best outcome would be what is referred to as the Grand Bargain. This would be an agreement which encompasses fundamental tax reform, rationalization of spending and real reform to entitlement programs. This type of comprehensive agreement would be greeted warmly by the stock market since it would mean that the uncertainty surrounding taxes would be over and that policymakers had finally put the needs of the country before their own political interests.

The precedent for this kind of deal exists in the work done by Democrats and Republicans back in the 1980's. At that time, however, Washington did not have the same level of partisanship which we have today. What the economy really needs is a plan to reduce the deficit steadily but slowly. As politicians on both sides of the aisle should acknowledge,

the federal budget is in chronic need of both tax reform and entitlement reform.

Some of the following questions and answers will address more of the specifics around our thoughts and the "fiscal slope."

A big thank you to our clients who continue to challenge us with great questions. Please let us know if you have any questions you would like to share with others.

Question: *What do you expect from the financial markets considering all the economic uncertainty?* **Answer:** Since we are assuming that a deal at some level, even if small, will be agreed upon, we expect that the negative fiscal impact will be approximately 1% to 2% as stated in our prior discussion. Our Base Case calls for slow but stable global growth (65% probability) in 2013. We would also expect growth to pick up in the second half of the year and to continue to strengthen into 2014-2015. Even with the challenge posed by the "fiscal cliff" in the US, the world is in somewhat better shape than a year ago when the risks were more acute, especially in Europe. The European Central Bank (ECB) has reduced European threats to the financial system through a program which provides for unlimited buying of the member states' sovereign debt. Most emerging markets have been lowering interest rates this year, and we should see the benefit in higher growth in China, in particular, in 2013.

In the US we are encouraged by the improvement in housing but still see slow growth of about 2%-2.25% in real GDP in 2013. We give a 20% probability to a Worst Case scenario in which the US economy does stumble over the fiscal cliff and all of the tax hikes and spending cuts currently legislated occur at year-end, thereby taking $600 billion of fiscal stimulus, or 4% out of the economy. This would probably put the economy into recession, and this scenario is not reflected in current stock prices.

We believe that our well-diversified portfolios with allocations to Fixed Income, US Large Cap stocks, International Large Cap stocks and Emerging Markets stocks and bonds would help us to navigate successfully through any potential negative market reaction. Another factor is that a lot of progress has been made in Europe and in the Emerging Markets, and this progress is not reflected in those markets.

We give a 15% probability to a Best Case of faster-than-expected growth. This would be the happy surprise which could come about due to reduced risk out of Europe, the improvement seen in housing in the US, and the possibility for a Grand Bargain on the US budget. If a Grand Bargain were to be reached that meaningfully addressed taxes and entitlements, this would provide strong support to stocks as investors anticipate a healthier economy spurred by renewed capital spending and hiring. In this case, our allocations to more cyclical asset classes such as US Small Cap stocks, Commodities and Emerging Markets stocks would stand us in good stead.

No one knows exactly how or when this issue will be resolved. We remain optimistic that some partial or full solution will be arrived at that precludes going over the cliff or slope. Neither President Obama nor Speaker Boehner really wants that eventuality as part of his legacy.

In the meantime, the volatility which may accompany the process will provide opportunities to buy into risk assets such as stocks and commodities at a discount. For clients who are fully invested, please remember that our portfolios are widely diversified and include Fixed Income, Cash and Hedge Strategies funds which will serve to buffer portfolios in times of market stress.

Months ago, someone told us that the difference between the budget issues in

Europe and the US was that, while Europe had the 'will' but not the 'way,' we in the US lacked the 'will' but had the 'way.'

The 'way' has always been a combination of revenue increases and spending cuts such as was outlined in the Simpson-Bowles Report by the National Committee on Fiscal Responsibility and Reform back in 2010. The title of the Simpson-Bowles Report was "Moment of Truth." We were disappointed that not enough attention was paid to this report at that time. We are pleased to note that both Alan K. Simpson and Erskine Bowles appear to be listened to a bit more now. We say, "Better late than never."

The Simpson-Bowles Plan importantly includes: discretionary and mandatory spending cuts, tax reform, healthcare cost reduction and reform, and social security reform and even now provides an intelligent outline of what must be done.

Question: *Will my taxes go up?* **Answer:** We will see higher taxes at several different levels, including a top tax rate that could go from 35 percent to 39.6 percent. We will also see an extra Medicare tax of 0.9 percent on wages above $250,000, and to the extent that your income is above $250,000, you may also pay an additional 3.8 percent on unearned income such as interest, dividends and capital gains. Another possible increase is the capital gains tax rate which could go from 15 percent to 20 percent. So……………...there is definitely a high probability that taxes will go up. The open question is by how much and on what type of income.

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As always, please keep us apprised of any upcoming cash needs which you may have. This enables us to raise cash well in advance of the need and at the most opportune time. Also, please continue to send us your questions. We will try to address as many as possible in future issues of the View from the Top.

The world of finance and investment is never dull and boring. Sometimes boring would be a really good thing, but until that day comes, we will continue to focus on ways to balance the risk and return.

Stay warm and enjoy the holiday season!

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