Impact of the “Fiscal Cliff” deal on the economy
by Bruce McCain, Chief Investment Strategist

Uncertainty is an archenemy for investors. The “Fiscal Cliff” legislation that passed Congress has alleviated some of the uncertainty and avoided some of the economic damage that weighed on the equity markets through the last months of 2012. Equities are rallying as an initial expression of investor relief. Realistically, however, Washington has merely kicked some of the important issues down the road – again – and has simply set the stage for another rancorous round of political brinksmanship in just a few weeks.

Key takeaways:
• The “Fiscal Cliff” legislation has alleviated some of the uncertainty and avoided some of the economic damage that weighed on equity markets in the last months of 2012.
• Realistically, Washington has merely kicked many important issues down the road and remains deeply divided on how we should reduce the Federal deficit.
• The rising tax on payrolls suggests discretionary consumer spending may grow more slowly in 2013.
• Businesses will continue to expand to satisfy higher demand, but will probably not invest with enough confidence to drive strong economic growth.
• Despite the higher taxes imposed and uncertainties surrounding how Washington will deal with the deficit crisis, the U.S. economy should continue to expand.

The legislation that Congress passed will prevent higher income taxes on most taxpayers, has made a number of the Bush tax cuts permanent and has reduced the impact of the Alternative Minimum Tax. While this should provide greater clarity for taxpayers, the legislation still provides only a small down payment on the government’s $1 trillion annual deficit. Washington remains deeply divided on the question of how we should reduce the deficit, so many of the small businesses that could drive faster economic growth may not feel that they know what their ultimate tax rate will be. Even worse, there seemed to be little evidence of bipartisan compromise in the way that Congress passed this legislation.

Although tax rates will not rise for most households, the rise of the payroll tax from 4.2% to the former level of 6.2% means wage earners
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will have less disposable income than they have had recently. Although the change is not a large increase, at the margin, it does eat up a substantial part of the annual growth of income that households have achieved over the last few years. Since the payroll tax increase will affect an estimated 77% of Americans, the rising tax on payrolls suggests that discretionary consumer spending may grow even more slowly than it has. Sluggish consumer spending has been a primary reason overall GDP growth has been disappointing over the course of this recovery.

Slower consumer spending would also mean reduced revenue for many small businesses. And while tax rates may be somewhat clearer than they were, small businesses continue to struggle with the costs of the Affordable Care Act and other new government regulations. We would not expect businesses that face rising costs or the prospects of slower revenue growth to invest aggressively.

Even worse, since little has been done to solve the deficit crisis, many businesses probably suspect that their tax rates may still go higher. That suggests that businesses will continue to expand in order to satisfy current demand, but will probably not invest enough to drive strong economic growth.

Consequently, the provisions of the new legislation seem to provide at least a modest drag on the U.S. economy without providing a framework, much less a solution, for the broader deficit crisis. Even so, despite the higher taxes imposed in the new legislation and uncertainties surrounding how Washington will ultimately deal with the deficit crisis, the U.S. economy should continue to expand.

While the new legislation implies a mildly reduced fundamental outlook for U.S. equities, overseas economies continue to improve. Reports out of the emerging markets continue to look promising and support decisions to increase exposure both to investments in the emerging markets and to investments leveraged to those economies. Particularly with the prospect of improved growth overseas, equities as a whole should achieve decent gains in 2013. As long as a solution to the deficit crisis remains elusive, investors should make sure they have enough overseas equity exposure to diversify the longer-term risks that this crisis poses for the U.S. economy.

If you have questions about the how the “fiscal cliff” deal could impact the economy and your investments, contact your Key Private Bank Relationship Manager.