# ALTMAN INVESTMENT MANAGEMENT

## MARKET PERSPECTIVE

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## IN BRIEF: Back From the Edge

On New Year's Day, the House finally voted 257 to 167 to support the President's proposed fiscal bill, which had been approved earlier in the day by the Senate with a surprisingly large margin of 89 to 8 votes. In the House, 151 out of the 236 Republicans voted against the bill, while in the Senate, the Republican Leader had supported the bill, as well as some other conservative Republicans. In short, the fiscal deal offers short-term assurance, while further deadlines still loom.

The fiscal measures are estimated to be worth around $600bn in additional revenue over 10 years. However, the precise nature of spending cuts is yet to be agreed: the bill delays the start of automatic sequestration by an additional two months. With several Republicans expressing concern yesterday about the lack of spending restraint present in the bill (which at one point looked set to threaten the bill's approval), and with their approval necessary to extend the debt ceiling, there is still considerable uncertainty as to how the debate will evolve concerning the debt ceiling extension in relation to spending cuts. These cuts are set to amount to $90bn under the sequester this year. It appears that the debt ceiling concession is likely to be reached later this quarter, possibly as early as mid-February. Additionally, another deadline is the expiry of legislation that provides authority to fund the federal government on March 27th.

House Majority Leader Boehner reasserted, after last night's vote, his position that there must be "meaningful reform of entitlements, real spending controls, and a fairer cleaner tax code". Meanwhile, President Obama said he was "very open to compromise", including cuts to Medicare. Still, it is important to bear in mind that the composition of Congress now changes, as retiring members leave and freshmen take their seats: hence, going forward, it could be more complicated to achieve consensus (given that retiring Congressmen are often thought to be more willing to compromise, particularly in relation to newly elected members).

### <u>Economic Implication:</u> Our 2.5% Year-over-Year GDP Forecast Remains Intact.

The agreement appears to support our expectation that fiscal consolidation this year would amount to around 1.5% of US GDP, and so would not necessitate significant revision to our GDP projections. We forecast that US GDP grows at an annualized quarterly pace of 1.5% in the first quarter, rising to 2.0% in Q2, and then 2.5% in Q3 and Q4. Nevertheless, much still depends upon what will happen with sequestration.

### <u>Key Aspects of Congress' Agreement:</u>

- **Expiration of payroll tax cut** - The temporary two percentage point reduction in payroll taxes for the first $113.7k of income will expire, resulting in fiscal drag on disposable income of $120bn (0.7% of 2013 GDP). The non-partisan Tax Policy Center said that 77% of workers would face higher taxes on account of this and other measures.

- **Expiration of upper-income tax cut; dividend and capital gains tax rate increased for upper-income households** - Only those earning, after deductions, over $400k (individuals)/$450k (married couples) will pay higher taxes, seeing their marginal rate increase from 35% in 2012 to 39.6%. As well, limits will return (as was the case pre-2010) on itemized deductions and personal exemptions, at $250k (individuals)/$300k (married couples). Estimates of the increase in revenues in 2013 from this measure range from $25-$50 billion. Additionally, for households earning more than these thresholds, the rate on capital gains and dividends will rise from 15% to roughly 20% - although Bloomberg has reported that, taking into account the 2010 health-care law, the top marginal rate would rise to 23.8%.

- **Tax cuts for those earning below upper-income tax thresholds made permanent** - If this measure (a key component of the 'fiscal cliff') had expired, it would have amounted to fiscal tightening estimated to be $120-$175bn.

- **A one-year extension of unemployment insurance benefits** (had this expired, it would have amounted to around $30-35 billion of additional revenue), **and refundable tax credits** for low-income households

- **The highest estate tax rate goes to 40%,** with exemption per person at $5million- inflation adjusted.

- **A permanent reform of AMT** - This measure is intended to remove the need to have "patches" for the AMT (Alternative Minimum Tax); the new measure makes a permanent reform that will entail the AMT being indexed to inflation. Estimates of the size of eliminating the patches on AMT have ranged from $47-$100bn, but details are still limited concerning the cost of the new measure.

- **Various tax breaks are to be extended during 2013.** These include the production tax credit for wind energy and tax credit for corporate research.

- **Spending cuts: The automatic sequestration delayed until March 1, 2013** - In line with Republican demands, the bill delays by two months the process of automatic sequestration (which would amount to $1.2 trillion over 10 years). The cost of the delay over two months has been estimated at $24bn, which is to be financed by a mixture of new tax increases and spending cuts, according to several congressional aides (cited by Dow Jones/WSJ). In particular, half of this cost ($12bn) would come from a shift in rules affecting 401(k) plans, to permit "Roth IRA plans" that would require holders to pay taxes up front on gains in their plans, but then to have tax free disbursements in retirement.

2013 could be a year in which a number of factors that have been holding back the US economic recovery are removed. This doesn't mean that the economy will soon start firing on all cylinders, but it does mean that the foundation for faster growth in a couple of years' time is falling into place. The current deal – along with the expectation of continued progress towards resolving US fiscal issues - should remove the risk of falling back into a recession and are constructive for rising equity prices.