

Leaning Left

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President Obama won a second term as president by three percent of the popular vote, while sweeping the battleground states and winning the Electoral College. Meanwhile, Democrats gained two seats in the Senate and the GOP held onto a comfortable majority in the House.

For investors, the personalities and party of the victors do not matter; what matters is the direction of policy. The most important is that federal spending relative to GDP – which peaked at a post-World War II high of 25.2% after the recession and is still an unusually high 22.8% – is not going to fall to 20% or below anytime soon, which was where it was consistently before 2008-09.

With government so big, the economy will not suddenly find a higher gear. The plow horse economy remains our base case forecast. But equities are still undervalued, significantly.

For policy, the election means the president's health reform law will remain in place. High income earners will face a 3.8% tax on interest, dividends, and capital gains, as well as an additional 0.9% Medicare tax on regular income.

In terms of the "fiscal cliff" – we like "taxageddon" better – let's start with the easy stuff. The president says he does not want military spending cuts to take effect and, given how inclined some in the GOP are to the Pentagon, we think most of those budget cuts will not happen.

On taxes, everyone knows driving off the fiscal cliff would be economic suicide. We think one overlooked possibility, given the complexity of the issues and lack of time, is an agreement to extend everything for one more year. This would give Congress and the president more time to work on something like Simpson-Bowles.

If this does not happen, then we expect compromises on the cliff. For example, rather than having the payroll tax rate rise by two points in 2013, we expect it to be spread over two years.

On the Bush tax rates, we think a compromise could be in the works that keeps the actual tax rates on income from going back up to where they were in 2000 and before. Both the President and Speaker Boehner have left the door open for making changes that do not lift the actual rates.

If the GOP offers to limit itemized deductions on high income earners by enough to raise the same amount of revenue that would be generated by lifting tax rates back to Clinton-era levels, we think a deal could be done. Even the liberal *Washington Post* looks favorably on the idea and this would be much better for incentives and economic growth.

For capital gains and dividends, we expect the official rates to go from the current 15% to 20%. Adding the extra 3.8% tax from the health care law would put both rates at 23.8%. That's higher than now, obviously, but the gains rate has hovered between 15% and 28% since the early 1980s and this new rate would be near the middle of the range, while the tax rate on dividends was 39.6% as recently as a decade ago.

Last and certainly not least, we expect the estate tax exemption to remain at \$5 million and for the top tax rate to stay near the ultimate compromise for the top income tax rate.

In other words, while there is always a chance that America will fall off the fiscal cliff, we expect calmer heads to prevail. In the end, we don't think the plow horse stumbles, but rather, continues to plod along.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-14 / 7:30 am	PPI – Oct	+0.2%	+0.1%		+1.1%
7:30 am	"Core" PPI - Oct	+0.1%	+0.1%		+0.0%
7:30 am	Retail Sales – Oct	-0.2%	-0.4%		+1.1%
7:30 am	Retail Sales Ex-Auto – Oct	+0.2%	+0.6%		+1.1%
9:00 am	Business Inventories – Sep	+0.5%	+0.7%		+0.6%
11-15 / 7:30 am	CPI – Oct	+0.1%	+0.1%		+0.6%
7:30 am	"Core" CPI – Oct	+0.1%	+0.1%		+0.1%
7:30 am	Empire State Mfg Index – Nov	-7.4	-6.2		-6.2
7:30 am	Initial Claims – Nov 10	375K	380K		355K
9:00 am	Philly Fed Survey – Nov	1.5	6.8		5.7
11-16 / 8:15 am	Industrial Production – Sep	+0.2%	+0.1%		+0.4%
8:15 am	Capacity Utilization – Sep	78.3%	78.3%		78.3%