Investment Commentary Quarterly

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Tsunami Averted, Subdued 2013

In my previous Quarterly, I outlined a base case for a pending recession in 2013. I adopted the expression "*Tax Tsunami*" which I believed better defined the impending, huge, across-the-board tax increases that could engulf our economy if the fiscal cliff was not averted.

The Congressional Budget Office (CBO) had reported that had a compromise not been reached, the Tax Tsunami would have driven the U.S. economy back into recession and result in a jump in the jobless rate to 9.1% by the end of 2013.[1]

At the very end of the "lame duck session" on January 1, 2013, a compromise called the American Taxpayer Relief Act (ATRA) of 2012 (H.R. 8) was passed by the United States Congress, and was signed into law by President Barack Obama the next day.

The American Taxpayer Relief Act retains many favorable tax breaks but also increases income taxes for high-income taxpayers. Highlights of the Act include:[2]

Income tax rates: Individual income tax rates will remain at 10%, 15%, 25%, 28%, 33% and 35% with only individuals earning more than $400,000 ($450,000 for married filing jointly) subjected to a higher rate of 39.6% for income above that thresh hold.

Capital gain and dividend rates: Taxpayers in the 35% and lower tax bracket continue to enjoy the 15% rate. Lower income earners in the 10% and 15% tax brackets will enjoy a favorable 0% rate. Individuals earning more than $400,000 ($450,000 for joint filers) will now pay a 20% tax on capital gains and dividends. With the new 3.8% surtax, the maximum rate will effectively increase to 23.8% for many higher-income payers.

Itemized deduction limitations: In more bad news for high-income taxpayers, the "Pease" limitation on itemized deductions was reinstated, affecting taxpayers making $250,000 ($300,000 for joint filers). This provision reduces the total amount of itemized deductions by 3% of the amount that adjusted gross income exceeds the thresh hold amount. The reduction will not exceed 80% of the otherwise allowable deductions.[3]

Permanent AMT relief: To the approval of many CPA's, including the IRS, ATRA permanently increased the alternative minimum tax (AMT) exemption amounts to $50,600 for single taxpayers, $78,750 for joint and $39,375 for married filing separately. The inclusion in ATRA is important because it avoids what could have been a month's-long delay in the ability to file income taxes as the IRS had already programmed its computers assuming AMT relief would be in place.

Payroll tax holiday ends: The two-year old payroll tax holiday was not extended. This now returns the employee's portion of FICA tax to 6.2% from the reduced 4.2% that they have been paying since late 2010.

Estate and gift tax rates: Estate tax exemptions were significantly increased to $5,250,000 per person and indexed for inflation using 2011 as the base. Prior to passing ATRA, the exemption amount was set to decrease to $1 million, with a top tax rate increasing to 55%. By passing the Act, Congress permanently increased the

[1] "CBO: 'Fiscal Cliff' Could Trigger Recession" , WSJ, November 8, 2012, Corry Boles
[2] " Congress passes fiscal cliff act", Journal of Accountancy By Paul Bonner and Alistair M. Nevius January 1, 2013
[3] American Taxpayer Relief Act Passes, January 2, 2013, Shepard Schwartz & Harris LLP

estate tax exemption and unified the exemptions from gift tax and generation-skipping transfer tax ("GST Tax") at the same amount with a top tax rate of 40%.[4]

On the positive side, the compromise forestalls a mix of huge tax increases and lesser spending cuts that would have done more damage than just push the nation into recession. I believe it could have also seriously weakened the rejuvenated housing sector, small-business growth, and put added pressure on the average American's balance sheet. With the compromise, we probably avoided a recession.

After further analysis of the deal, I view the compromise as a victory for a majority of Americans who now have more clarity about their tax liabilities. ATRA should protect against the devastatingly significant fiscal contraction that the CBO had projected had the Tax Tsunami hit our economy. This is a major plus for U.S. economic growth in the short-term.

Fiscal Drag for 2013 GDP

However, before investors become overly thrilled with the compromise and begin wholesale equity purchases, we have to remember that higher taxes will result in lower GDP growth. In other words, the compromise that Wall Street is cheering will reduce GDP growth in 2013.

The Tax Policy Center, a joint venture between the Urban Institute and Brookings Institution, estimated that the compromise will increase taxes on the average American by $1,257 per household in 2013.[5] The CBO reports that the new tax increases are estimated to reduce U. S. GDP in 2013 by 1.5 percent.[6]

We have to also factor in the new 3.8% Obamacare tax and a 0.9% increase in the Medicare payroll tax on investment incomes above $250,000. According to Economics editor and financial host Larry Kudlow, when you add the Obamacare and additional tax hikes together, small business owners, earners, and successful investors are looking at a roughly 12 percent decline of incentive rewards from higher risks, lower profitability and less take-home pay.[7]

The size of the fiscal drag is substantial; however, the tax increase alone should not drive the economy back into a recession. Nevertheless, it will likely keep growth from returning to its potential next year and temper employment gains.

Federal Spending Levels and Debt Control

Unfortunately, the deal failed to increase certainty about many of the country's fiscal issues. The CBO's January 2, 2013 analysis of ATRA estimates that the fiscal cliff deal will add $3.9 trillion to the debt over the next 10 years.[8]

ATRA includes an expensive one-year extension of unemployment benefits, a provision that proved to be a prerequisite for most Democrats. More importantly, from a market uncertainty perspective, the deal failed to tackle federal spending levels or debt control to any great extent. Congress basically punted the difficult work, leaving that for future rancorous negotiations.

Therefore, the new 113th Congress will now have to address the difficult task of spending cuts and entitlement reform almost immediately with the unsettling back drop of: 1) the sequester, which was only delayed for two months, 2) the debt ceiling, which will have to be increased by March, and 3) the Continuing Resolution to fund the government, which needs to be acted upon before the end of March in order to avoid a partial government shutdown.

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[4] Ringing in the New Year with Revised Estate and Gift Tax Laws, 1/9/2013, Manatt, Phelps & Phillips, LLP
[5] Tax Provisions in the American Taxpayer Relief Act of 2013 (ATRA) James Nunns and Jeffrey Rohaly January 9, 2013
[6] H.R. 8, American Taxpayer Relief Act of 2012". Congressional Budget Office. January 2, 2013.
[7] One Cheer For a Cliff Deal that could have been Worse, Real Clear Markets, Larry Kudlow, January 4, 2013
[8] H.R. 8, American Taxpayer Relief Act of 2012". Congressional Budget Office. January 2, 2013.

Investment Uncertainty

Because of theses substantial issues, the significant and direct linkage between politics and economics is likely to persist in 2013. Continued congressional polarization most probably extends policy uncertainty, impairs debt and deficit negotiations, and inhibits economic growth.

While investors may initially have cheered the fiscal cliff deal, they soon will need to brace themselves for even more polarized debate coupled with political brinksmanship, resulting in last-minute deals that undoubtedly may not significantly alter America's current fiscal trajectory.

As these issues come into focus and the rhetoric is amplified, I expect we could see more accompanying market uncertainty and increased volatility for the foreseeable future. The uncertainty could unfortunately keep US economic growth below its potential capacity and strong investment returns will be challenged.

Investment Implications

Washington, unfortunately, will not be giving investors any time soon a clear signal as to which road to travel. A grand bargain at the end of 2012 would have been the green light for equity markets, which would have been supported both from the reduction in near-term uncertainty as well as an increase in confidence that would have accompanied bipartisan fiscal reforms.

Alternatively, being hit with the Tax Tsunami would have been the green light signal for U.S. Treasuries, which would have been buoyed by the flight from risk assets like equities to the stability of Treasuries by global investors fearing a looming U. S. recession. Instead, ATRA delivered to investors mixed signals. Components of the ATRA deal favor fixed income investments while other parts are moderately favorable for equities.

In my opinion, ATRA all but eliminated the possibility of the most damaging equity market outcomes. The lower taxes and accompanying lower fiscal drag in 2013 reduces the likelihood of near-term recession. And, while certainly not an example of stellar legislating, ATRA did reduce the tax rates for the majority of Americans. All of these factors should support equity investing, at least in an economy that has become conditioned to expect sub-par GDP growth.

Recent Fed action tying future central bank policy to economic variables, such as a 6.5% unemployment rate rather than their "Dual Mandate" also serves to increase the equity markets' attractiveness. Because of the artificially low interest rates manufactured by the Bernanke Fed, U.S. equity markets are beginning to look like the only lady in a desolate Alaskan bar.

Finally, and on a more optimistic note, I view the Master Limited Partnerships (MLP's) and Tax-exempt Municipal Bonds as beneficiaries of the ATRA deal. First, some of the tax reform proposals discussed during the fiscal cliff debate included an end, or at least a curtailing of the municipal bond tax exemption, and the limiting of the tax-advantaged distributions of MLP's as a tactic of increasing tax revenues without increasing tax rates. The deal removes those risks. Second, the increase in the highest marginal tax bracket increases the marginal benefit to an investor of holding an MLP or a Tax-free Muni bond.

I continue to favor high-quality income-producing securities for several reasons. Many other investments such as stocks in general are unlikely to provide meaningful earnings gains on a risk-adjusted basis, in the near term, especially during the uncertainty over the next few months as congress addresses the debt ceiling, sequester and the continuing resolution to fund the government.

Subdued 2013

Most Wall Street forecasters are projecting faster economic growth in 2013. Unfortunately they always do, because on Wall Street, they are basically paid to be optimistic

As the earnings reporting season begins in earnest, Thomson Reuters is reporting that the “forward 4-quarter” earnings estimate for the S&P 500 is 113.88.[9] This is a new all-time forecast top for this key benchmark. This is a 14.3% increase from Thomson Reuters 2012 estimates. This, in my analysis, is a bridge too far.

The Four Forces

I have estimated that S&P 500 operating earnings will be flat for 2013 at about $99.50. My estimate is based on four realistic forces. First, the fiscal cliff uncertainty during the fourth quarter of 2012 will spill over into 2013. The continued congressional polarization most probably extends policy uncertainty, confounds debt and deficit negotiations, and inhibits economic growth.

Second, the new 3.8% Obamacare tax and a 0.9% increase in the Medicare payroll tax hike combined will be a monkey wrench in a major engine of growth in America’s small business owners. A significant decrease in the risk/reward equation will undoubtedly reduce GDP growth and job creation in 2013.

Third, a deepening recession in Europe and Japan will depress corporate revenues for S&P 500 companies. (About 17% of revenues and profits of S&P 500 companies come from Europe)

Fourth, a strong dollar will hurt foreign earnings as revenues of U.S. - based multinationals turn into fewer dollars, (This drag has already appeared in many third quarter 2012 earnings reports).

Currently, few forecasters are projecting these lower forecasts. However, after weighing all the factors and economic components discussed in this report, I believe that moderate U.S. growth is the best America can realistically expect in 2013, especially with the negative effects of my four forces.

It is problematic crafting an investment outlook for 2013 at this juncture since we are awaiting a true indication of 4th quarter earnings and corporate 1st quarter projections. Nonetheless, I am fairly certain that growth is going to be hindered in 2013 and earnings growth is unlikely to measure up to the sky-high priced-to-perfection expectations. That might not translate into negative equity returns given the Fed’s zero interest rate influence. However, I believe it is prudent to manage the beginning of 2013 against near-term downside risks.

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[9] http://www.trpropresearch.com/pdf/The_Directors_Report.pdf/