First Trust
Monday Morning OUTLOOK
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Thelma, Louise and the Fiscal Cliff

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Everyone knows it's coming. Thelma and Louise are about to drive off the cliff, in one last climactic scene of independence and stupidity. You don't have to rent the DVD because our very own federal government is heading toward the fiscal cliff. It should be spectacular.

If a new budget agreement can't be reached by the end of this year or early next year, federal spending gets automatically trimmed – sequestered – by $70 billion through September 30, 2013, about half of it from the defense budget. In perspective, government spending will be about $2.7 trillion from January to September 2013. So, we're only talking about 2.6% of total spending – or 0.6% of GDP – over the last nine months of the fiscal year, which ends September 30.

No doubt this would hurt defense contractors and other recipients of government business and aid. But spending crowds out the private sector, so cutting spending by this little and showing that Washington is starting to get its fiscal house in order would probably have a positive effect on GDP, even in the short-term. Spending was cut about this much at the end of the first Iraq War in 1991, and the economy grew.

What concerns us more is the tax side of the fiscal cliff. These include (1) the end of the 2% payroll tax break of the past two years - $120 billion in extra revenue per year. (2) A new extra 3.8% tax on dividends, capital gains, and interest income and a 0.9% Medicare tax on high earners - $25 billion/yr. (3) lower thresholds for the Alternative Minimum Tax - $100 billion-plus. (4) A return to the 2000 tax rates on income, dividends, and capital gains, including a top official rate of 39.6% on ordinary income and dividends and 20% on capital gains - $150 billion-plus.

Right now, we see the odds of a recession at 25%. However, if all of these tax hikes happen at once, our odds of recession would have to go up considerably.

Our best guess is that the 2% payroll tax cut won't be extended again. That, by itself, is not cause for much concern. Personal income is up $460 billion in the past year, so workers have enough income growth to absorb a reversal of the payroll tax cut and still increase their purchasing power. The economic expansion would survive.

The real threat is a simultaneous impact on investment and work effort from higher marginal tax rates on ordinary income, dividends, and capital gains combined with the unsettling impact on consumers and investors of losing a significant portion of their expected cash flow. As we wrote last week, we may be living in an era in which the economic cycle is more dominated by shifts in monetary velocity and the risk of a panic. If so, a major and sudden shift in tax burdens could be a cause for recession even if the supply-side effects on incentives are relatively small.

These tax hikes would not only damage the supply-side of the economy, but would subtract hundreds of billions of dollars of income from the private sector. Both sides of the political aisle understand this, which is why, in the end, we are still confident some agreement will be reached (as it was in 2010) regardless of the outcome of the election.

We do not expect an agreement before the election; the chances of that are extremely low. And we don't expect a very quick agreement afterward; both parties have an incentive for brinksmanship to drive the best possible bargain for their supporters. Instead, get ready to wait until the waning days of any lame duck session, and watch the signals coming from the proverbial smoke-filled rooms for an agreement.

We do not expect tax rates to rise anywhere near high enough to cause a recession. Our base case remains that the US will continue to grow right through 2013. The Plow Horse will plow on despite the fiscal cliff. The stock market "gets" that and that's why it's going up despite the threat of the fiscal cliff.

Let the credits roll.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-11 / 7:30 am	Import Prices – Sep	+0.8%	**+0.9%**		+0.7%
7:30 am	Export Prices – Sep	+0.4%	**+0.4%**		+0.9%
7:30 am	Initial Claims – Oct 06	368K	**371K**		367K
7:30 am	Int'l Trade Balance – Aug	-$44.0 Bil	**-$43.9 Bil**		-$42.0 Bil
10-12 / 7:30 am	PPI - Sep	+0.8%	**+0.9%**		+1.7%
7:30 am	"Core" PPI - Sep	+0.2%	**+0.2%**		+0.2%
8:55 am	U. Mich Consumer Sentiment	78.0	**78.5**		78.3