First Trust
Monday Morning OUTLOOK
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Heard the One About a "Fiscal Cliff"?

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For three years the market has suffered from a severe case of economic hypochondria. Headline after headline proclaimed that this time, for sure, the recession would return. Remember Dubai and Tunisia? What about deleveraging, re-setting adjustable rate mortgages, credit-default-swaps, foreclosures, Greece, state and local budget cuts, rising energy prices, the debt ceiling, unemployment, the Super Committee, or the S&P downgrade? All of these have come and gone…and yet the recovery is three years old.

Now, some doomsayers are pointing ahead to a "fiscal cliff" in 2013. The supposed cliff is a combination of possible policy changes all happening next year. These include the sunset of the "Bush tax cuts" (on regular income, dividends, capital gains, and estates), the end of the payroll tax cut, and the planned cuts to federal spending.

The theory is that the combination of higher taxes and lower spending will push our economy right back into recession. We don't think this is going to happen and investors should not waste time worrying about it. First, regardless of the outcome of the presidential election, we think the most likely policy result is a continuation of most, if not all, of the Bush tax rates, at least through the end of 2014.

If a Republican wins the White House, they are also likely to control the House and Senate. This would allow them to keep those lower tax rates (or cut them even further!) with simple majorities, through the budget reconciliation process. In other words, they would not need Democrat votes.

If President Obama wins re-election, he may want to end the lower tax rates on regular income, dividends, and capital gains for high-income taxpayers. But the Republicans would likely retain the House, and so Obama could not extend the tax cuts for the middle class unless he capitulated on extending them for everyone. His advisors, with their eyes then moving toward the 2014 elections, will tell him to extend those tax cuts one more time, just like they did back in 2010.

Worst case scenario: we go back to the tax rates we had under President Clinton. This would hurt the economy, but for many reasons investors should ignore this unlikely scenario for now.

By contrast, the end of the payroll tax cut is likely. Neither side really likes this policy. Conservatives argue that it's temporary and it's not really a cut at the margin. Liberals worry that cutting payroll taxes severs the link between worker "contributions" and future benefits, which could ultimately undermine political support for the Social Security program.

From an economic point of view, ending the break will not significantly alter the course of the economy. Personal saving is now running at an annual rate of about $540 billion. Returning the tax rate to 6.2% would cost workers about $120 billion per year. Given that personal saving hovered around $270 billion per year from the early 1980s through 2007, the loss of the tax cut can be more than made up for by reduced savings. History suggests the economy will survive.

The least of our worries is the scheduled slowdown in federal spending. We don't see how the economy gets on a truly sustainable growth path without a significant decline in federal spending relative to GDP. What would worry us more is if politicians found a way to wiggle out of their promises and spending continued on its unsustainable growth trend.

Bottom line: expect to hear more about the "fiscal cliff" for the next several months. Then, when it doesn't cause a recession, you'll never hear about it again.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
3-27 / 9:00 am	Consumer Confidence - Mar	70.1	**70.0**		70.8
3-28 / 7:30 am	Durable Goods - Feb	+3.0%	**+6.4%**		-3.7%
7:30 am	Durable Goods (Ex-Trans) - Feb	+1.7%	**+2.5%**		-3.0%
3-29 / 7:30 am	Q4 GDP First Report	+3.0%	**+3.1%**		+3.0%
7:30 am	Q4 GDP Chain Price Index	+0.9%	**+0.9%**		+0.9%
7:30 am	Initial Claims – Mar 24	350K	**350K**		348K
3-30 / 7:30 am	Personal Income - Feb	+0.4%	**+0.3%**		+0.3%
7:30 am	Personal Spending - Feb	+0.6%	**+0.6%**		+0.2%
8:45 am	Chicago PMI - Mar	63.0	**62.7**		64.0
8:55 am	U. Mich. Consumer Sentiment	74.6	**75.0**		74.3