DISCIPLINE • BALANCE • PERSPECTIVE

Maryland Capital Advisors

ECONOMIC UPDATE **December 13, 2012**

A Look at the Fiscal Cliff: Does it Mean Much for Investors?

Although economic performance so far this year has not been that bad, with U.S. GDP increasing at about a 1.5% to 2% pace, analysts and investors are increasingly worried that a major fiscal policy mistake regarding the so-called fiscal cliff could derail the expansion and throw a "monkey wrench" into the positive equity market performance this year.

Those worries about the fiscal cliff are real and should not be ignored. A combination of expiring tax cuts at year-end, including the 2001/03 Bush-era tax cuts, and initial reductions in federal spending at the beginning of 2013 (the sequester), represent up to $700B or over 4% of GDP – enough to cause a recession sometime during 2013. *Even if Congress and the White House agree to "fix" the cliff, the cliff may very well be merely reduced to a more moderate slope, but a slope still large enough to tip a slow-moving U.S. expansion into a mild downturn next year.*

While this might be enough to send investors heading to the hills and raising cash, all is not lost and investors should not overreact. The case for a very good outcome is still on the table. In their wisdom, both Congress and the Obama administration have tied the actual cliff negotiations to three other very important items on investors' agendas:

- Setting up a framework to achieve at least $3 trillion in 10-year deficit reduction, which would be enough to stabilize the debt to GDP ratio (currently 80% versus the pre-financial crisis ratio of approximately 40%),
- Establishing a mutual goal of meaningful corporate and individual tax reform with lower tax rates and a broader tax base,
- Making sure the government does not default in early 2013 when the debt ceiling expires

If a fiscal cliff agreement includes all those items, the outcome would be very positive for the markets. Of course, estimating the timing of all this is very difficult – we think it may not be resolved until early 2013.

In any event, even if the worst is averted: a self-induced recession is avoided next year and the prospects brighten on all fiscal policy fronts, investors should be aware that tax rates on investment income are going up sharply at year-end 2012. *There is little prospect of investment tax rates for upper-income investors to be any lower than 20% next year compared to 15% in 2012. But investors should avoid making quick decisions about their investments just because the fiscal cliff "might" hurt them.*

M. Cary Leahey
Economic Consultant

Cary Leahey is a private economist engaged by Maryland Capital to share his expertise with our clients. He is also a senior advisor to Decision Economics, where he retired in 2012 as Chief U.S. economist. He has appeared in major media outlets including CBS, NBC, BBC and CNBC and is frequently quoted in the press. Previous positions include Chief US Financial Markets Economist at Lehman Brothers, where he was the senior "Fed watcher" and at Deutsche Bank, High Frequency Economics, General Motors, Data Resources and the White House's OMB and CEA staffs. He earned a PhD from the University of Pennsylvania and is a Phi Beta Kappa graduate of Clark University.