CONWAY• JARVIS LLC
Investment Outlook

Volume 22 Issue 10 Post-Election 2012

The Fiscal Cliff Lights a Fire in Washington

This edition of our Investment Outlook will address the post-election negotiations over the Budget Control Act of 2011 that is scheduled to take effect on January 1, 2013.

"Winning"

That was the phrase delivered with a wink and a smile by TV actor Charlie Sheen last year as his career spiraled out of control. Of course, we were all in on a joke that he was the last to get. Now, a little more than a month after the presidential election, the phrase is being tossed around in Washington as political capital in negotiations over deficit reduction. We're among those who want to see the two parties come together in crafting an actual plan to control the deficit. But this time we get the sinking feeling that we're the brunt of the joke.

As predicted, not much was changed by the election. We have the same cast of characters on stage who are cemented in their opposing ideologies and dispensing the same tired sound bites. Political will, personal courage, and leadership remain just as scarce as before. It would seem that the election was simply something to be contested and won rather than a catalyst for change in the course of the US economy. All we can say is thank goodness for the fiscal cliff.

That's the Budget recovery Act of 2011 and the only reason "negotiations" are being feebly pursued. We say feebly because the past month has become little more than a long and tedious victory lap by the White House, Senate Majority Leader Reid, and House Minority Leader Pelosi. Their "negotiating" strategy looks more like spiking the ball in the end zone after a touchdown. They seem to have mistaken the outcome of the election for a mandate to "tax the wealthy" while leaving *entitlement* programs untouched. Their words, not ours. That's hardly the "balanced approach" to deficit reduction they've been hawking this past year. To us, it appears that they're "Winning" while the long-term future of the US economy spirals out of control.

"Waiting"

That's where we find ourselves today. In our last Outlook, we voiced our belief that both parties would find the "cliff" so unpalatable that they would crabwalk cautiously to the middle to cobble together a meaningful, not grand, compromise. House Republicans have voiced their intent to put tax revenues on the table. That's not an explicit admission that they'd accept higher rates for the top 2% of taxpayers. However, it's hard to miss the signals John Boehner is sending that Republicans would capitulate and do exactly that IF revisions are made to a Medicare program that, left as is, will be insolvent in 10 years. That's not only a reversal of policy but a repudiation of Grover Norquist's and the Tea Party's principles surrounding taxes. It's a significant chip being played to arrive at a compromise.

Unfortunately, those signals are being missed by some in Congress where Harry Reid counts the end of a war as the cornerstone of a long-term deficit reduction program and Nancy Pelosi last week announced there would be *no* change to *any* entitlement program flowing from these negotiations. Fortunately, we expect a cooler head in the White House to prevail over such posturing and craft a compromise. We believe this president values his legacy over the narrow agendas of his party leaders who, at best, will be only footnotes in his Wikipedia profile.

That's why we're expecting a deal to be completed in the short-term between the president and House Leader Boehner and why the stock market has shrugged off those recent negative comments from both Reid and Pelosi. Whether it occurs before or shortly after year-end is immaterial to us and so far it appears the markets are just as sanguine about when it happens, as long as it's soon. As with most things, the devil's in the details and that's what we're waiting for. A brief step over the cliff is likely to be a non-event for the equities markets. What will be of more concern is how government spending and taxing will be affected. Too little of the former and too much of the latter in the short-term could deliver a serious blow to the recovery and tip us back into recession.

Beyond the Cliff

The balance of taxing and spending by government is analogous to the conditions of the sea to which a helmsman has to adjust the course of his vessel. So too does business in the private sector have to adjust to conditions that arise from changes to fiscal policy. If an ample dose of certainty is added to the financial landscape, we have no doubt that the economy can recover, even with the Obama tax increases in place. Of greater concern are the new taxes and costs associated with the Affordable Healthcare Act and how they could affect individuals. ***A nervous US consumer could tip a low-growth recovery of the economy into recession. Until we see the details of any deficit reduction plan, we'll remain defensive in the very short term with our larger than normal cash allocation in portfolios.***

We think any deal will initially move stocks higher if it isn't front-loaded with too much austerity and truly changes the trajectory of the deficit 10 years from now. It's what happens after the deal that will determine whether 2013 is a good year for investors. We've had 11 recessions since 1948 and there will inevitably be another. A step off the "cliff" could make that sooner rather than later or turn out to be nothing more than just a step in the right direction: toward fiscal responsibility and deficit reduction in the long-term. That will require something we haven't seen from Washington through several administrations. We're hoping that "Winning" and "Waiting" gives way to "Governing" in the years ahead.

www.conwayjarvis.com