CONWAY• JARVIS LLC
Investment Outlook

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A View From the Edge of the Fiscal Cliff

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

The Election

With the debates behind us and the polls showing the presidential candidates locked in a close race, we'll take this opportunity to offer our view of the general election. **Having no reason to take exception to recent poll results, we believe President Barack Obama will retain the presidency while the balance of power in the Senate and the House will remain unchanged.** We'll dispense with any further analysis since our goal is not to spark debate but rather to provide a foundation for moving on to the subject of what's likely to happen after the election and how we expect the markets to react.

The Aftermath

Will the stalemate in Washington be broken? That's the question inquiring minds ask when looking to the future. There are those who say a second-term president inevitably moves to the middle in order to secure a lasting legacy of accomplishment. That requires the opposing party to join the president and his party in that middle ground to engineer a compromise. We're hopeful this will be the case in this president's second term but have some doubts that such a magnanimous display of pragmatism and statesmanship will come easily. We don't view the following as the *probable* outcome but rather a worst-case scenario that has to be considered in our view of the markets.

First, the president: He's already made history, not only with his election but also with the passage of the Affordable Care Act. Regardless that Obamacare was not the result of a widely popular bi-partisan groundswell of support and that it was later deemed by the Supreme Court to be tax legislation rather than healthcare reform, it was groundbreaking and will be viewed by history as the jewel of his presidency. Along the way, he's positioned himself as a defender of the under-classes and advocate for an aspirational middle-class. This role has resonated with many and he's garnered much support, and votes, by leveraging a view that "fairness" demands that those who can afford to pay taxes should pay even more to sustain and expand social programs. This completes a profile that, in the minds of many, already places him in the pantheon of US presidents. **Not wanting to sully his legacy, it's likely he wouldn't agree to revisions in Entitlement Programs unless they were accompanied by tax increases on high-earners.**

And now Congress: It's unlikely that Harry Reid and John Boehner would agree on the shape of a perfect circle. As leaders, one might think that, when faced with potentially dire consequences for the economy, they would come together to fashion a solution that would serve the interests of a broader constituency that extends beyond their respective parties. In our view, that's unlikely. Reid is secure in his position as Senate Leader since he's the ideological favorite of his party's extreme base. It's doubtful he'll come to the middle on his own, absent intervention by a higher authority. Any compromise by House Speaker Boehner would no doubt involve an endorsement of a tax increase in some form. This would enrage not only Tea Partiers in the House but also undermine his support from those members that have signed Grover Norquist's (Americans for Tax Reform) pledge to vote against *any* tax increase. **Boehner's retention of the speaker's chair could be threatened and that might prevent him from rallying his ranks to join Democrats and the president in any "Grand Compromise" that calls for a tax increase.** The result? The stalemate persists.

This is our worst-case scenario, one where no compromise is fashioned and the provisions of the Budget Control Act of 2011 take effect at year-end. Will it happen? Not likely. This would mark an abrupt beginning of both spending cuts and tax increases. Yes, this would reduce the deficit but it could also threaten the fragile, low-growth recovery of the US economy and increase the probability of recession in 2013. This is something to be considered when crafting a tactical approach to investing for the next year. In our view, the *probable* post-election outcome is that both parties and the president find the consequences of inaction to be so unpalatable that they reluctantly come together in a compromise that employs the strategic, balanced approach to deficit reduction set forth by the Bowles-Simpson Commission. If that doesn't happen?

Say Hello to the "Fiscal Cliff"

That's the shorthand term for the Budget Control Act of 2011 that becomes law at year-end if Congress and the president can't come to an agreement. It has different meanings, depending on who you are. For politicians, it threatens their control of the purse strings in Washington and how much pork they can deliver to their constituents. Defense contractors and their employees fear for their profits and jobs. Investors fear the effect of another recession on their portfolios. Those not affected? Welfare and Food Stamp recipients, seniors receiving Social Security and Medicare benefits, and other programs deemed "mandatory" or essential. Unfortunately, that category accounts for roughly 60% of the federal budget and will still require revisions somewhere down the road to avoid larger, potentially crippling tax increases.

Speaking of taxes. Going over the fiscal cliff impacts all taxpayers, not just high earners. Rates will rise across the board. This "broadening" of the tax base is a component of the Bowles-Simpson plan and one embraced by *moderate* Republicans. It's also antithetical to the Democratic leadership's desire to shift the burden of paying federal income tax to a *minority* of Americans. This is where the battle lines will be drawn and where the possibility of a compromise emerges. The quid pro quo will likely be revisions to Entitlement programs and cuts in discretionary spending exchanged for a streamlining of the tax code. That means eliminating some deductions and nudging the tax burden up for high earners. That increase in tax revenue will have to exceed any increase in spending and directly *reduce* the deficit rather than *increase* the financing of redundant social programs and wasteful discretionary spending.

If a compromise is fashioned this way, neither party will have secured all of what they've promised to supporters. That's symptomatic of most great compromises. This outcome would not only change the trajectory of the government's budget over the long-term, but also instill confidence in the private sector by eliminating the current uncertainty over what fiscal policy might dictate year-to-year. This should serve to trigger a more fully engaged recovery by enticing companies to invest their storehouses of capital. The benefit to employment is obvious as is the resulting increase in demand that will spur consumption. **In this case, a "Lose-Lose" deal for politicians could create a "Win-Win" result for the economy.**

Investing Around the Fiscal Cliff

A win for the economy usually means a win for its markets. We've laid out our worst-case scenario as a *possibility*, not a *probability*. Since we have to choose one side of the fence or the other, we'll invest for a rational, probable outcome in the immediate post-election period. However, that doesn't call for betting the farm on what the folks in Washington are likely to do. **Anything can happen and we view the current level**

of uncertainty as having capped returns from the market this year until it's clear that a compromise will be accomplished. Without one, it's more likely that stocks retreat from these levels on fears that abruptly higher taxes and cuts to government spending will trigger at least a mild recession sometime in 2013. That's why we've been busy in the last month reducing over-weighted positions and liquidating some growth issues that have failed to deliver on earnings estimates. We've retained most, if not all of our value-income issues since they've been meeting modest earnings expectations while paying generous dividends. The net effect has been an increase in cash levels and a lessening of portfolio volatility.

We should note that, at this stage in the recovery, we no longer see a threat to the structural underpinnings of the financial system. That reduces the chances for another dramatic "Fear On, Risk Off" contraction in equity prices. Instead, we see greater potential for weaker stock prices from a cyclical downturn triggered by a step off the "cliff". That would impact stock prices negatively but in a more measured manner rather than a return to the "crash" mentality of 2008. **With that in mind, we still maintain a mildly bullish stance, based on our expectation of a successful compromise on the budget and implementation of a plan for deficit reduction.** If that appears likely, we'll hasten to put our cash back to work. For now, we remain alert to indications that our worst-case scenario can be averted. If not, there is some good news: A failure to compromise will deliver a painful lesson, but it will nevertheless mark the beginning of the deficit reduction process.

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