ANALYTICS INVESTMENT ADVISORS, LLC

The Fiscal Cliff

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December 15, 2012

The Problem…

> *"The fiscal cliff was not created by aliens from outer space. It is another poor government program created in Washington".*
>
> *James Taylor*[1]

The Solution…

> "*The path to progress in economic policy lies… in the mutual undertaking to work out the best possible combination of fiscal, monetary, and wage price policies… for reconciling sustained high employment with reasonable price stability".*
>
> *Walter Heller*[2]

The Outcome…

> "*If no action were to be taken, the size of the fiscal cliff is such that there's… absolutely no chance that the Federal Reserve… could or would have any ability whatsoever to offset that effect on the economy… and send the U.S economy over a fiscal cliff and into another recession".*
>
> *Ben Bernanke*[3]

The fiscal cliff is commonly defined as an unusual combination of tax increases coincidental with reductions in federal spending, all on January 1, 2013. It was the result of the deficit reduction plan in 2011 to serve as shock treatment for finding responsible alternatives later. As Martin Feldstein observed, "inaction on the fiscal cliff poses a *substantial treat* to the recovery and that the U.S. economy is perilously close to the edge of another recession even if the fiscal cliff is avoided. With the economy growing at less than 2 percent, that may be too small a cushion to withstand fiscal tightening resulting from a budget agreement". [4] In this context, given that:

• Business investment in equipment and software stalled nationwide in the third quarter for the first time since early 2009;

• Corporate executives are slowing or delaying projects to protect profits amid easing demand and rising uncertainty;

[1] Stanford University, Barron's 11/12/2012, p 24.
[2] Heller, Walter: *Monetary vs. Fiscal Policy,* W.W. Norton, New York, 1969.
[3] Articles.latimes.com/2012/jun/07/business/la-fi-bernanke-economy-20120608
[4] Moneynews, November 20, 2012

• Labor conditions are weak, and as uncertainty becomes more prevalent, income and spending remain fragile and continue to decline;

• The labor participation rate is the lowest in 30 years, resulting in an 11.1% effective rate of unemployment;

• Year over year core retail sales continuing to drift lower in-line with the soft aggregate earnings and weak consumption trends;

• Nondefense capital goods orders declined 10% year over year in September;

• The federal debt in excess of $16 trillion equates to 100% of GDP, concurrent with another trillion dollar deficit projected for 2013;

• The net present value of unfunded liabilities for Social Security and Medicare total $63 trillion dollars;[5]

• The European economy is slowing and likely to enter another recession in 2013;

• China's economy is languishing and the demand for its imports declining;

• Leading and coincident indicators continuing to show uneven growth; and,

• GDP growth is projected to grow at a tepid 2% pace in 2013,

…it is hard to imagine a robust economic scenario for America in 2013, (and beyond) regardless of what congress and the executive branch decide concerning the fiscal cliff, unless significant and tangible efforts are made to address and ameliorate in a bipartisan manner the long term misdirection and wasteful spending of the U.S. government.

The stock market is a function of corporate profits, which in turn are dependent on GDP growth and labor costs. The goal should be to incentivize businesses to invest and expand aggregate demand through innovation, thus creating jobs, increasing disposable income and maximizing tax revenues, while at the same limiting government outlays to some specific and fair percent of GDP.

[5] Cox, Chris and Bill Archer: *Wall Street Journal*, November 27, 2012, p. A17.