First Trust
Monday Morning OUTLOOK
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The Cliff Ain't So Bad

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Last week, fresh off the election, it looked like Democrats and Republicans could quickly forge a bipartisan agreement to avoid the fiscal cliff. President Obama was talking about raising taxes but wasn't wedded to higher tax *rates*. Meanwhile, Speaker Boehner put higher revenue on the table, as long as tax rates did not go up.

So they could have extended all the tax cuts just one more year – the "Bush" tax cuts dating back to 2001/03 as well as the payroll tax cut – and then gone to work on proposals like the Simpson-Bowles long-term budget plan. Or, in the alternative, they could have kept all income tax rates where they are, including a top rate of 35%, and raised tax revenue from the upscale by limiting itemized deductions.

Instead, President Obama is now asking for $1.6 trillion in higher taxes over ten years, which, in combination with pushback against tighter limits on itemized deductions, requires higher tax rates. In fact, Keith Hennessey, former head of the National Economic Council, thinks Obama and Boehner never meant the same thing when they were talking about tax rates. Boehner meant not lifting tax rates above today's top rate of 35%; he thinks Obama meant not lifting the top rate *above the 39.6% where it was already scheduled to go next year*.

As a result, it now looks like a toss-up whether we hit January 1 without an agreement. So get ready for the doomsaying punditry to go crazy over the next few weeks.

By contrast, we do not think there is anything special about January 1. Most firms issue their first paychecks of the year on or after January 15th, and would have until that time to change withholding. Taxes on capital gains and dividends earned in 2013 are not due until April 2014. The Alternative Minimum Tax has to be "patched" for 2012, but those who owe AMT generally wait until March or April to pay their taxes.

In the end, we still think an agreement is highly likely because an uninterrupted dive off the fiscal cliff would cause a recession. In the end that agreement will likely contain some higher tax rates for investors. The official tax rates for capital gains and dividends would probably end up at around 20%. Extra taxes in the health care law would make the effective rate 23.8% on higher incomes.

Higher taxes on investors would certainly not be good news, but it would also not be a reason to panic or flee from the stock market. From the end of 1986 through the end of 1996 the S&P 500 went up 12% per year, excluding dividends, and the total return was 15% per year. Yes, that includes a huge rally in 1995-96, but it also includes the crash in 1987.

And during that entire period, the capital gains tax rate was 28% and the top tax rate on dividends (treated as regular income) went from 28% to 31% to 39.6%. In other words, higher tax rates on investment than we are likely to get next year did not prevent a bull market.

What really mattered during this timeframe was that the size of government was shrinking. Federal spending fell from 22.5% of GDP to 20.2%. At the time, it was the largest drop in any ten-year period since the wind-down after World War II. Ultimately, it's the government spending that matters because spending redirects resources from the more productive private sector to the less productive government sector.

Given the election and the inevitable implementation of the health care law, we don't expect a significant reduction in government spending. Nonetheless, agreement on the fiscal cliff is likely to trim government at the margin – even though it will be far less than we think is necessary.

Despite all this, as we recently explained, based on earnings and interest rates, the stock market is cheap. This is true, even if interest rates were to rise.

It is entirely plausible that some investors end up playing the fiscal cliff negotiations exactly right – selling recently as the fear rose and then buying before the market rises on an agreement. But this kind of perfect trading is rare. More likely, investors playing the cliff will wait too long and be underexposed to equities when the rally starts. We don't know how to trade these things. Instead, when equities are undervalued, it's better to stay invested all along.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
11-19 / 9:00 am	Existing Home Sales – Oct	4.750 Mil	**4.740 Mil**	4.790 Mil	4.750 Mil
11-20 / 7:30 am	Housing Starts – Oct	0.840 Mil	**0.815 Mil**		0.872 Mil
11-21 / 7:30 am	Initial Claims – Nov 17	410K	**440K**		439K
8:55 am	U. Mich Consumer Sentiment	84.5	**85.0**		84.9
9:00 am	Leading Indicators – Oct	+0.1%	**+0.1%**		+0.6%