The Fiscal Cliff: Scenario Analysis

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Overview

The U.S. economy is faced with a significant risk as we move closer to 2013 — a risk created by our own government tax and spending policies. The media has dubbed this risk “the fiscal cliff” and it is described as a drag in the economy created by automatic tax increases and spending cuts totaling an estimated $670 billion. At 3.5% of 2012 U.S. Gross Domestic Product (GDP), it could drag the U.S. economy back into recession. However, policymakers could act to stem this “economy killer.” In our view, there are three primary possible outcomes to this issue:

- No policy actions, which would likely lead to a U.S. recession in 2013 on the order of negative 3%.
- Policymakers blunt some of the spending cuts and/or tax increases, but not all of them. In this scenario, we likely get a stall in economic activity with 2013 GDP averaging between negative 1% to positive 1%.
- Recognizing the modest state of the current economic recovery, policymakers could forestall all the effects of planned tax increases and spending cuts, which would likely leave economic growth in the 2%-3% range.

In our view, the most likely scenario is for politicians to try to fully mitigate the current policy cuts. We estimate the probability of more negative economic outcomes around 35%, with the worst outcome offering just a 10% chance. We also see a 15% possibility for stronger outcomes. These would likely be driven by stronger business spending or multiplier effects of stimulus by emerging market economies. The average of these possible events likely leaves GDP growth for 2013 a little slower than 2012, likely averaging around 1%.

<table>
<thead>
<tr>
<th>Potential 2013 Fiscal Headwind (in billions of dollars)</th>
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<tr>
<td><strong>Provision</strong></td>
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<tr>
<td>Bush tax cuts for middle income</td>
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<td>Extended unemployment insurance benefits</td>
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<td>Alternate Minimum Tax (AMT)</td>
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<td>Sequestration cuts*</td>
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<td>Discretionary spending</td>
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<td>Bush tax cuts for wealthy</td>
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<td>Tax extenders</td>
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<td>Extended unemployment insurance benefits</td>
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<td>Physician payment cut</td>
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<td><strong>Total</strong></td>
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Source: ISI; *automated spending cuts

Important disclosures provided on page 4.
In the following, we take a deeper look into the probabilities of each possible scenario and analyze their potential implications.

**Scenario: Full Fiscal Cliff**

**Action:** No action is taken and all of the increases and spending cuts go into effect  
**Probability:** 10%  
**GDP Expectation:** -3%

Current law dictates that about $500 billion in fiscal tightening will start in 2013. We put the probability of this occurring at 10%. There may be some tightening, but we anticipate Congress will extend or roll back most provisions.

If Congress doesn’t act, the tax cuts originally put in place in 2001 and 2003 expire and the automatic spending cuts that were designed during the debt ceiling debate in August 2011 are set to begin. The full extent of fiscal tightening at the start of 2013, if allowed to occur, would be about $500 billion, which is about 3%-3.5% of GDP. Such sharp curtailment would be unparalleled and likely push the economy close to a recession, so we anticipate Congress will ultimately act to remove most of the tightening, although we expect they may wait until the eleventh hour.

**Scenario: Partial Fiscal Cliff**

**Action:** Compromise is made and only some of the tax increases and spending cuts go into effect  
**Probability:** 25%  
**GDP Expectation:** -1%

The partial cliff will take place if Congress compromises and only some of the tax increases and spending cuts actually take place. We see the partial cliff creating a 1.5%-2% drag, depending on the extent of the compromise. GDP growth will likely slow to negative 1%, potentially pressuring employment somewhat, leading to a modest rise in the unemployment rate to around 8.5%. This will possibly ease inflation as core rates remain below 2%, perhaps dropping toward 1%. We give the partial fiscal cliff scenario a fairly high 25% probability as Federal Reserve Chairman Ben Bernanke has suggested he hopes Congress will come up with some sort of compromise similar to this so that the fiscal contraction is smoothed out over time rather than occurring all on one day. We believe leaders will make their best efforts to kick all of the tax increases and spending cuts down the road, but there is a good chance that some will stay in effect and cause a modest drag on the economy.

**Scenario: Kick the Can**

**Action:** All of the tax increases and spending cuts are postponed to a later date  
**Probability:** 50%  
**GDP Expectation:** 2%

Despite Chairman Bernanke’s warnings, we believe that current political and economic conditions make it likely that a lame duck Congress will temporarily extend current policy, effectively “kicking the can down the road.” This outcome would not be the first time that Washington has extended a number of Bush-era tax cuts. In December 2010, after widely publicized partisan wrangling, a temporary extension passed the Senate (81 in favor and 19 opposed) and the House (277 in favor and 148 opposed). Leaders from both parties deemed the passage of the act necessary to help maintain a frail economic recovery.

Corporate earnings and employment data have improved since 2010. However, it appears Congress has remained largely divided as taxation and the economy continue to be headline battleground issues with the November elections approaching. Given the high political stakes during any Presidential election year, the prospects for continued inaction are strong. The 112th Congress is more evenly divided between Democrats and Republicans than its predecessor.

GDP growth for first quarter 2012 was 1.9%, slightly lower than during the second half of 2010. Austerity measures have exacerbated economic decline in Europe and U.S. policymakers are not oblivious to the cautionary tale of the eurozone recession, especially when faced with a decision to address fiscal concerns at the expense of growth.
Both the political and economic climates today mirror those in 2010, leading us to conclude that the most probable outcome for the pending fiscal cliff scenario is another temporary extension of current fiscal measures. We foresee GDP growth continuing to hover around 2% and unemployment in the 8% range as businesses remain reluctant to make meaningful investments at a time when the future of domestic fiscal policy is so uncertain.

Although we generally see “kick the can” as a positive outcome, our upside potential is moderated by the risk of a potential downgrade of U.S. debt. The major rating agencies have indicated that the continued inability by Congress to reach an agreement on how to reduce the deficit is a major consideration when reviewing the U.S. credit rating. In the event of the kick the can scenario, we put the probability of a debt downgrade as fairly likely. Although Treasury prices soared during the last downgrading as the U.S. continued to be viewed as a safe haven, we believe a 2013 downgrade will carry greater consequences, causing interest rates to rise, which may result in a contraction in consumption and investment.

**Scenario: Moderate Growth**

| Action: A clearer tax code and accommodative housing policy relieves the negative impact of the fiscal cliff | Probability: 15% | GDP Expectation: 3% |

In the most optimistic case, some combination of individual tax reform, corporate tax reform and new housing policy could add meaningfully to GDP growth — particularly a corporate tax cut. Incorporating lower probabilities of action due to short-term political and fiscal difficulties, however, leads us to a likely gain around the 1%-2% (additive) range. A corporate tax cut could lead to a pickup in wages, which is a primary component of inflation, and leads us to our 3% estimate. If new housing policies successfully reduce the inventory overhang, housing-related employment could begin to improve, pushing the unemployment rate back into the 7.5% range.

**Will business confidence help the U.S. achieve moderate growth?**

We see business confidence languishing in 2013 under a kick the can scenario. The uncertainty surrounding fiscal and monetary policy that may ensue, coupled with possible exogenous shocks from the eurozone, and the distinct possibility of a slowdown in emerging market growth, could put a lid on business confidence. It is our hope that Congress will eventually address the questions of our budget deficits and growing public debt and make repatriation of profits, closing of corporate tax loopholes and competitive corporate tax rates a part of that conversation. Business confidence is affected by many variables. However, as of May 2012, we do not see any such variables that affect aggregate demand being impacted in a positive manner to bolster our opinion about business confidence.

**Will stimulus from the emerging markets help the U.S. achieve moderate growth?**

Emerging market economies, notably Brazil, Russia, India, and China, are all poised for faster growth rates in 2012 and 2013 than are the developed market economies. Rising labor costs throughout emerging market economies will likely make U.S. labor costs more attractive to domestic manufacturers. More jobs (re-shoring) should come back to the U.S. Increased pay for workers in China and India will provide them with more purchasing power. U.S.-headquartered global companies should continue to enjoy increased demand for their goods and services from fast growing overseas markets. There is a high probability (75%) of a positive effect on GDP. However, the actual effect is projected to be small (>0.25%) due to slowing countries economies now trying to stimulate their economies.
Key takeaways

- Our view is the most likely outcome will be for politicians to mitigate most, if not all, of the drag from the potential spending cuts and tax increases, either through extension or creation of new policy. This outcome should allow U.S. economic growth to continue at a slow pace of around 2%.

- We believe there may be a one in three chance that politicians are unable to fully offset the planned tax increases and spending cuts, with a one in ten chance that they do nothing at all. In both these scenarios, the U.S. economy likely falls into a recession, with the worst case outcome a moderate recession.

- A moderate growth scenario would likely involve mitigation of the impending “fiscal cliff,” coupled with one of a number of optimistic scenarios. Scenarios involve a “grand plan” of tax and/or housing policy changes, the altering of the current tax code to generate future stability, or perhaps significant stimulus in emerging market nations which could have a very positive effect on U.S. economic activity. In our view, this scenario offers a meager 15% probability of occurrence.

- Combining these scenarios leaves us with a modestly positive forecast for 2013, offering around 1% economic growth. Despite the possibility of a moderately positive outcome, the risks of the relatively negative scenarios drag down our average forecast.

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