

# US Fiscal Cliff Deal: A Stopgap, Not a Solution

Russ Koesterich | January 02, 2013 | Topics: [Equities](#), [Economic Outlook](#), [Fixed Income](#)

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## 18 Implications of the Last-Minute Agreement

### Overview

- The fiscal deal is better than nothing...but its limited scope and the need for additional negotiations will likely translate into increased volatility for financial markets.
- For the economy, we expect a rebound later this year but believe GDP growth is unlikely to exceed the 2% annual clip we have seen in recent years.
- For equities, we prefer US mega-cap companies and non-US stocks. Dividend stocks look attractive, especially those companies that are cash-flow rich and have a track record of increasing payout rates.
- Within fixed income, we like to focus on credit. Municipal bonds also remain a good source of tax-exempt income for US investors, but US Treasuries look dangerous with yields low and duration risk high.

The New Year began with Congress finally agreeing to a partial deal to avoid (or at least delay) the much-discussed "fiscal cliff" of scheduled tax increases and spending cuts. In the following pages, BlackRock provides an overview of the deal and discusses what it means for the economy and financial markets.

### What does the fiscal cliff agreement include?

1. Here's a quick summary of what the fiscal cliff agreement reached late on January 1 covers:

- Permanent extension of the Bush-era tax rates for individuals with income up to \$400,000 and couples with income up to \$450,000.
- Permanent maximum 15% tax rate on dividend income and long-term capital gains for individuals and couples up to those same income levels, with a 20% rate for those with higher incomes.
- Permanent lower estate tax rates for estates worth up to \$5 million.
- Permanent fix for the Alternative Minimum Tax.
- Two-month delay of scheduled spending cuts (known as the "sequester").
- One-year extension of unemployment benefits.
- One-year freeze on scheduled cuts in doctors' Medicare payments (the "Doc Fix").
- Five-year extension of stimulus-related spending cuts.

2. Significantly, the deal did *not* include an extension of the payroll tax holiday, any entitlement reform, any restructuring of personal or corporate tax codes or any increase of the debt ceiling.

3. The bottom line: The agreement does mitigate the full impact of the scheduled tax hikes and spending cuts, but it is incomplete in many ways. The compromise will still produce a modest fiscal drag, fails to address the longer-term fiscal challenges facing the United States, and leaves the debt ceiling as an unresolved, near-term issue.

### What does the deal mean for the near-term economic outlook?

4. The fiscal drag left in place by the deal, coupled with the lingering uncertainty surrounding

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While it seems unlikely, should Congress and the White House be able to strike a broader "Grand Bargain" this year, we would

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the debt ceiling, leads us to expect a weak economic start to 2013. The market consensus currently is for first-quarter growth to be roughly 1.6%, a rate we find to be overly optimistic. We do expect the US economy to rebound later this year, but it is unlikely to accelerate above a 2% annual growth rate.

5. In particular, we expect consumption levels to be weak. Consumers are still struggling with tepid income growth and high debt levels. The fiscal cliff deal adds three additional headwinds for consumers. First, the expiration of the payroll tax holiday will hit workers' take-home pay to the tune of \$30 billion per quarter. Second, upper-income households will face higher taxes on several fronts. Last, the late timing of the deal means that tax filing this year will be delayed – as will tax refunds, which totaled more than \$200 billion in the first quarter of 2012.

6. The uncertainty over the debt ceiling and the potential for another showdown in Congress suggests that capital spending will remain constrained.

7. For the near term, the deal does not change our positive view on the US dollar. While it may seem perverse, a protracted debate over the debt ceiling, leading to a debt downgrade and a period of risk aversion, could actually strengthen the dollar. However, over the longer-term the dollar is likely to come under renewed pressure if the US fiscal position deteriorates.

8. Given the many issues left unresolved (the debt ceiling, entitlement reform, the sequester, tax code reform, etc.), Washington is likely to remain focused on fiscal issues for the foreseeable future. We therefore expect little progress on other pressing matters, including immigration reform, trade agreements, or energy policy. In addition, this domestic focus suggests the United States is unlikely to provide much global leadership.

9. A contrarian would see upside potential to all of this. While it seems unlikely, should Congress and the White House be able to strike a broader "Grand Bargain", we would expect to see significant tailwinds for the economy and financial markets.

### **What does the deal mean for the US budget outlook?**

10. The fiscal cliff deal does very little in terms of altering the long-term US fiscal picture. It will not significantly reduce the high US debt-to-GDP ratio. Tax revenues are expected to increase by about \$600 billion over the next decade, but do not come close to addressing the US fiscal imbalance.

11. Even in the short-term, deficits may actually be larger than expected. The White House Office of Management and Budget's latest assessment projected growth levels of 2.7% for fiscal 2013 and assumed an average growth level of 4% over the next four years. As these growth estimates are unlikely to be reached, revenue levels are likely to disappoint and deficits may be above estimates. Finally, with the debt ceiling soon to be breached, failure to act increases the odds of another US credit rating downgrade.

### **What does the deal mean for financial markets?**

12. First, we expect to see more volatility. While higher volatility should present buying opportunities for investors with longer time horizons, investors should be prepared for a bumpier ride in 2013, at least until Washington produces a more definitive, longer-term agreement.

13. Regarding investment opportunities in equities, we would focus on US large-and mega-cap companies. We believe global growth (including emerging markets growth) will surpass growth levels in the United States, implying that companies with greater exposure to the global economy should outperform. This suggests a higher allocation to large - and mega-cap companies, which are generally less sensitive to domestic growth.

14. At the same time, we would advise investors to reduce any overweight positions they may have to US stocks as a whole. US companies are highly profitable and reasonably priced, but they are somewhat expensive relative to other markets currently. Instead, we believe investors should consider overweighting emerging markets, smaller developed countries, and peripheral European exporters. While these areas of the market face their own challenges, valuations are generally more forgiving and growth estimates may be less prone to disappointment.

15. Additionally, we suggest investors remain cautious on US small caps and consumer stocks, which typically fare relatively poorly in slow-growth environments.

16. We do believe that dividend stocks look attractive. While dividend tax rates will increase for some

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taxpayers, the deal should not have a significant effect on dividends. The change in tax treatment is quite modest and will only impact a small percentage of taxpayers. In any case, US companies have a history of making investors whole on an after-tax basis and with current payout ratios near historic lows and balance sheets quite strong, companies have ample room to raise dividend payments to compensate investors for any changes in tax treatment.

17. Regarding fixed income, we believe that slower growth levels imply that Treasury yields will stay low for at least the first half of 2013.

Treasuries, however, still look unattractive to us. Real yields are negative and duration risk is high, which means that even a modest increase in yields would have a significantly negative impact on Treasury prices. We suggest investors focus

on credit sectors of the fixed income market, with a particular emphasis on high yield, bank loans, structured credit (including commercial mortgage-backed securities, collateralized loan obligations and non-agency mortgages) and emerging markets debt.

18. Finally, we believe municipal bonds remain competitive on a tax-adjusted basis for US investors. Higher marginal rates for at least some investors, along with little prospect of changes to municipal bonds' tax status, make munis even more attractive on an after-tax basis. While we are unlikely to see significant capital appreciation for municipal bonds, their after-tax yields are attractive and munis remain a solid source of income.

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### [Outlook 2013: Fiscal Cliff Remains Unresolved, but Opportunities Still Exist](#)

Russ Koesterich

Although the early part of 2013 will still be dominated by fiscal cliff drama, BlackRock Chief Investment Strategist Russ Koesterich sees several investment opportunities in the year ahead.

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