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Dwelling on a "Cliff" Deal

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Battle lines have begun to form around the so-called "fiscal cliff." These lines will, of course, shift and waver in coming weeks. That is the nature of negotiations. In the process, financial markets will alternately suffer bouts of fear and relief. The give and take, in all likelihood, will go on to the last possible minute. That, too, is the nature of such negotiations. But for all the doubts that will rise and fall in the interim, probabilities suggest that the talks and maneuvers in the end should keep the nation from going off the cliff. The exact nature of coming compromises remains vague. But the positioning to date gives at least a hint of their nature.

The general feeling at the moment is that the Democrats have the advantage. The election, after all, put Mr. Obama back into the White House, modestly enlarged the party's Senate majority, and gave Democrats small gains in the House of Representatives. But still, Republicans retain a solid majority in the House and have the ability to block legislation in the Senate. Especially since there is dissension within as well as between the two parties, neither side has the power to impose its will on the other. What is more, both sides face tremendous pressure to compromise. If each hopes that the public would blame the other side for failure, the prospect of recession, which would almost certainly accompany a fall off the cliff, simply carries too much risk for most politicians. Even such tough partisans as Senate majority leader Harry Reid (D-NV) and House minority leader Nancy Pelosi (D-CA) have bowed to the imperatives of the moment and have begun to talk in terms of "grand bargains" and "compromise." Pelosi said bluntly, "We want agreement," while Reid decries "brinkmanship."

The biggest cliff issue is the expiration of the Bush tax rates. Republicans want to extend these lower rates for all. President Obama and the left of the Democratic Party insist on keeping the rates low for all but higher-income earners. The president points to the election to claim that the majority of the public is on his side. He has a point, but it is not all his way. At least one-third of the Republican caucus in the House has pledged never to raise tax rates on anyone. Obama knows that his election victory means little to these representatives. Their political careers would end if they broke their vow. Their seeming intransigence raises the risk of failure should the president stand firm on his point, and the president knows that failure would impose considerable pain on his constituents. Taxes would rise on the middle class (as well as the wealthy). Non-defense discretionary spending would suffer more than $50 billion in cuts. Extended unemployment compensation payments would end suddenly, and the burden of alternative minimum tax (AMT) would impose on much of the middle class. Medicare services would weaken, because a scheduled 27% cut in doctor's fees would prompt many medical doctors to exit the program.

Faced with such an impasse, both sides might well embrace tax reform. Some way to reduce statutory tax rates while at the same time eliminating or capping tax breaks would offer a way out of the awkward impasse on the Bush tax rates. Reform proposals of this sort have found favor at times on both sides of the isle. In the past, Republicans have only countenanced such reforms if they were revenue neutral, but, opening an avenue for compromise, House Speaker John Boehner (R-OH) has already indicated that he would accept revenue enhancers. Even the Republicans who have pledged themselves against voting for new taxes could square increased revenues with their pledge, since tax rates would not rise in a reformed structure.

Right now, the president offers the biggest impediment to the reform solution. Though he has embraced such reform principles in the past, he wants first to impose higher tax rates on wealthier Americans and then negotiate reform from those higher rates. For this reason, he has argued an elimination of deductions or capping them would fail to provide sufficient revenue. "The math," he said, "tends not to work." But analysts on both sides of the political spectrum say that the government could generate considerable revenues in this way. Those analyses have had effect. Many, even within the president's own party, seem reluctant to risk failure for the sake of the administration's two-step process. A

centrist group called the New Democratic Coalition has formed within the party. Amounting to at least one-quarter of the Democratic caucus, it has made clear that it wants to embrace the new Republican openness to revenue increases within a reform effort. Combined with the 15 remaining conservative Democrats, the so-called "Blue Dogs," mostly from southern states, this new coalition could add considerable force for compromise.

Similarly, the pressure of the cliff seems to have made Congress more open to entitlements reform. Republicans, of course, built part of their campaign around it. Now, while the Democratic left still rejects entitlements reform out of hand, the pressures of the moment have raised other voices within the party. Some would only permit minor adjustments, but others, led by Senator Dick Durbin (D-IL), would consider bolder ways to contain entitlements spending. Bolstered by work done at the left-leaning Center for American Progress, these new Democrat positions focus on raising the eligibility age for Medicare, means trusting for benefits, introducing competitive bidding for some services, and seeking savings by paying for medical outcomes instead of fee for service. Even President Obama has tipped his hat to such proposals, though only in general. They are, of course far from Republican positions, but still no less a partisan than Senate minority leader Mitch McConnell (R-KY) has characterized them as a basis for compromise.

If such compromises would still leave the country far short of complete fiscal reform, they would avoid the fiscal cliff, or at least the bulk of it. Any combination of entitlements and tax reform, especially with enhanced revenues, would count as sufficient deficit reduction to avoid the automatic discretionary spending cuts, the so-called sequestration, currently built into law and a big part of the fiscal cliff. Tax reform, even if it were to fall far short of ideal, would also sidestep the debate over the Bush tax rates and spare the economy that part of the cliff as well. Congress, having jumped such hurdles, could then easily pass another annual AMT "patch" to block an extension of this particular burden to the middle class. Nor should Congress have difficulty protecting Medicare services by blocking the planned cut in doctors' fees. Congress has done this so frequently in the past that the legislation has a nickname, the "doc fix." Not only could the economy miss the fiscal cliff this way but also, for those with an optimistic turn of mind, the compromises, jury-rigged as they inevitably will be, could perhaps even lay the foundations of something more substantive.

CRITICAL RELEASES IN THE WEEK AHEAD
by Milton Ezrati

Of all the releases and announcements scheduled for the week, the most forecasting information will arrive on Wednesday, December 12, at 12:30 p.m. ET, with the release of:

FOMC Meeting Announcement

There is little reason to expect a surprise here. The Federal Reserve should reaffirm its conclusion that, given the economy's fragile state, it will have to hold interest rates low for an extended time and also continue its now open-ended quantitative easing program. It may reaffirm its earlier decision to end Operation Twist with the new year.

OTHER IMPORTANT RELEASES
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Thursday, December 13, at 8:30 a.m. ET, will see the release of:

	Previous	Prospective
Retail Sales for November	**+**3.8%	+0.5%

This first official glimpse of the holiday shopping season should have a confused mix behind it. The preliminary reports of post–Thanksgiving spending look strong, but the overall retail sales data will also include effects from Hurricane Sandy and a likelihood that the unsustainably strong October release will correct.

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Friday, December 14, at 9:15 a.m. ET, will see the release of:

	Previous	Prospective
Industrial Production for Number	**-**0.4%	+0.1%

Because the ISM release for this month was so weak, little in the way of a bounce back from a weak October is likely.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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