Astor Asset Management

THE FISCAL SLOPE
An Analysis of the Fiscal Cliff

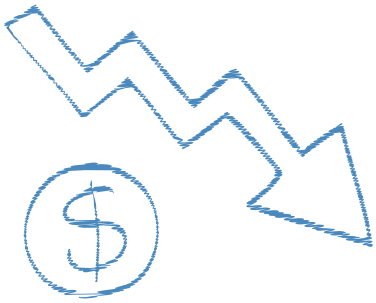
As we transition to post-election life, activity on Capitol Hill will overwhelm headlines through year-end as corporations and individiuals focus on the looming "Fiscal Cliff".

WHAT IS THE "FISCAL CLIFF"?

A collection of tax increases and spending cuts totaling $607 Billion will come into effect on January 1st if a deal is not agreed upon. The tax increases result from the expiration of tax cuts enacted under President Bush in 2001 and 2003, which would push the top individual rate to 39.6% as well significant changes to estate taxes. Additionally, health care, payroll, and alternative minimum tax provisions will change. Along with the tax law changes, spending cuts brokered as a resolution to last year's debt limit crisis will start and continue through 2021 as a way to clear up over $1 trillion.

There has been little preparation in Washington because both sides thought they would win the election and thus be able to adjust the outcome to their liking. There are less than 45 days left to reach an agreement which involves passing through the Senate, House, and the Oval Office. President Obama's stance has larger focused on increasing taxes to the rich which means letting tax cuts expire for incomes above $200,000-$250,000.

POSSIBLE IMPACT



By accident or design, the debt ceiling will again bind around year end and many observers expect a deal for will happen. The lessons learned from last summer include the Treasury has a certain amount of flexibility as to when it breaches the ceiling (several months) and that the standoff makes for a nervous and volatile market- the S&P fell 15.5% in a few weeks last year (July 20 – August 8, 2011).

The consensus of economists is GDP would be about 4% lower next year than it would be otherwise if no deal is done. That would possibly plunge our economy into a recession towards the mid-part of the year. There is no reason to expect a discrete drop in economic activity on January 1st as the term "Fiscal Cliff" implies. It is unfortunate that the cliff metaphor has stuck. "Fiscal slope", "deficit incline", or "net revenue glide" would have been more accurate, though less likely to sell newspapers. Risk assets would sell off in the face of any major negative economic implications. Specific asset classes, such as dividend- yielding stocks, may experience more impact due to the nature of the tax laws. Dividend taxes would increase from 15% to ordinary income rates. "Flight to quality" assets such as investment grade bonds and Treasuries will likely see increased attention.

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ASTOR'S PERSPECTIVE

Our view of the situation is that the Democrats are in a stronger bargaining position as they can offer to cut taxes on 90% of the population, a deal Republicans may have a hard time turning down. A variable is the extent to which House Republicans will continue to resist any deals with the Obama administration as a goal in itself. That is, if the Republicans will be obstructionist for obstructions sake. Our guess is that a deal will be made which will reduce the deficit somewhat next year, and hence be a drag on growth, but will try to defer most of the budget balancing to the future. There is a significant chance that it will take a severe market reaction (stocks down and bonds up) to concentrate the minds of the negotiators, as it is only natural to try to maneuver for advantage if the cost does not seem high.

On the balance, we expect the political negotiations between now and December to add stock market volatility but with a deal being inked early in the New Year. A good result would be a quick deal that defers most of the net revenue increases to the future when the U.S. economy is better able to handle it. A bad outcome would be renewed default scare (with the consequent sharp drop in stocks) accompanied by current law being enacted (leading to a large drop in GDP over the course of the year).

It will be imperative for managers and investors alike to take a nimble approach in the coming weeks and months. The specter of a failed agreement has already put fear into the financial markets and led to allocation shifts in portfolios. With or without a deal, expect volatility in financial markets. To the extent a failed deal has residual economic impact; we stand ready to adjust our exposure appropriately. Any deal will likely only serve to kick the can down the road until the next expiration date.

Astor Asset Management LLC is a money manager specializing in an active approach to investing. We believe that investment opportunities arise based on the ability to identify fundamental trends and changes in the economic environment. Our investment philosophy revolves around identifying the current phase that an asset class or economy is experiencing of its cycle and investing accordingly using exchange-traded funds. Formed by former Federal Reserve analyst Robert Stein, Astor Asset Management LLC is a subsidiary of Knight Capital Group, Inc. (NYSE Euronext: KCG).

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