How We'll Painlessly Avoid The Fiscal Cliff

The Fiscal Cliff is forecast to represent 2.9% of GDP drag in 2013 if nothing is done, according to the Congressional Budget Office (CBO). Although it was originally intended as a mechanism to force Congressional compromise around bringing the Federal budget under control, with less than seven weeks until the automatic tax hikes and spending cuts take effect the focus is now clearly on simply avoiding the blunt instrument of fiscal policy that it represents.

The CBO's analysis breaks down the different pieces of the Cliff and calculates the impact of each on GDP. Assessing the likelihood of compromise on each one provides an interesting perspective on the likely resolution.

1) Raise Taxes on the Rich – this has received the most attention by far. The President wants to raise taxes on those single tax filers making more than $200,000 and joint filers making more than $250,000. The Republicans will likely agree to higher taxes in some form. That will be one consequence of their poor showing in the election. "Rich" may eventually be defined as income above $500,000 or even higher, but it really doesn't matter. That's because the CBO estimates that even if tax rates for this group were restored to their "pre-Bush" level and investment income was all taxed as ordinary income, the entire impact would be to slow GDP by 0.1%. The optics matter because the "shared sacrifice" that must ultimately include entitlement reform can only occur in conjunction with some sacrifice from the 2% or 1% (depending on the definition of "Rich"). The Republicans have already indicated some flexibility on their opposition to new taxes so while it will grab headlines, wherever they ultimately settle on this issue it won't impact the economy much.

2) Allow the temporary reduction in the payroll tax and emergency unemployment benefits to lapse. This is probably going to happen – neither party has expressed much interest in extending these. The CBO believes this is worth 0.7% to 2013 GDP.

So now we have 0.8% of fiscal drag already imposed on the economy, as well as the effects of Hurricane Sandy (estimated to cost 0.5% during the current quarter). Let's look at the remaining components of the Cliff as measured by the CBO.

3) Restore the pre-Bush tax rates on everybody else. This is worth 1.3%. The Republicans are against this, and the President has focused on raising taxes on the rich. How hard are the Democrats really going to push to raise taxes on the middle class under these circumstance? It's likely both sides will agree to defer this item.

4) Automatic cuts in Defence, 0.4%. A complete non-starter.

5) Automatic cuts in non-Defence Discretionary spending, 0.4%. There's some room for symbolic cuts to remain, by way of demonstrating resolve, but it's unlikely to be close to this figure.

The beauty of the Cliff is Congress created it and Congress can alter it. Neither side is likely to find much benefit in causing more GDP drag than the 0.8% or so illustrated above. So having decided they've done enough, or made a "down payment" as John Boehner has said, the Cliff will be avoided. The announced settlement will include a commitment to a broad-based overhaul of the budget and perhaps tax reform, to be negotiated in 2013. Will they include another Fiscal Cliff by way of forcing Congressional action? Possibly, although the President will undoubtedly push back on that.

Under different circumstances during these negotiations the President and Congressional leaders would be maintaining a watchful eye on the bond market for its approval of fiscal discipline, and to a lesser degree the rating agencies. Except that, as a barometer of such things the Bond market no longer works. The Federal Reserve is by far the biggest buyer of bonds and since they're not economically motivated interest rates won't be allowed to respond by voting on the outcome. Perhaps the most powerful visible incentive on budget makers to negotiate difficult compromises will be silent at this time. As such, the motivating features for both sides will be contemplating the visible cost of fiscal drag through tough decisions without the benefit of lower borrowing costs for the government or the penalty of higher costs if action is insufficient.

Equity investors are enduring a difficult time right now, and that may continue through year-end. However, it seems likely that a fairly modest GDP headwind and catastrophe avoided will be where we ultimately wind up. We can all wring our hands about the long term cost of such an approach, but take the world as you find it.

We continue to own solid businesses with good prospects and strong balance sheets that will be around no matter what happens, because we're probably going to see another can kicked down the road. We like Microsoft (MSFT) whose cashflow generation continues and is priced at an attractive less than 7X FY June 2013 EPS ex-cash; Berkshire Hathaway (BRK-B), which at under $85 is close to levels at which they could buy back stock (as much as 10% above $76.29 book value, or $83.92). We recently added to Kraft Foods Group (KRFT) which yields almost 4.5% and will comfortably cover its $2 dividend with $2.60 of EPS next year. Following a good earnings report we sold Energizer Holdings (ENR) since the battery business is shrinking by a startling 7% per annum and they're likely to have to cut pricing to stay competitive which will hurt their margins. And we maintain an investment in the Gold Miners ETF (GDX) since reflation is where central banks are going and Europe is demonstrating the futility of too much fiscal discipline too soon.

Timing is invariably difficult, but it’s possible to see a negotiated solution that can turn out fine even if it once again delays the day of reckoning.