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U.S. Election Implications for the Fiscal Cliff

There are many reasons for optimism as the US continues its economic recovery, including a stabilising housing market, improving employment data, an adaptable labour force, reduced manufacturing and production costs associated with falling natural gas prices, and the US's continued role as a leader in technology development. However, amid high levels of sovereign debt, headwinds do remain. One of these is the expiry of a number of fiscal stimulus measures, which could result in what Ben Bernanke has dubbed "the fiscal cliff."

The fiscal cliff refers to a number of tax-relief programs due to expire on December 31, which will coincide with the launch of several spending-cut initiatives. If none of these tax-relief programs are renewed and/or no spending-cut initiatives are deferred or reduced, the impact threatens to push the economy off the fiscal cliff and into recession. So far compromise has been elusive as Democratic and Republican negotiations have been at a standstill, preventing meaningful fiscal reform.

Last week's U.S. election results did not provide a consolidation of power within one party, which would have improved the potential for decisive progress (one way or the other) on the U.S. fiscal policy crisis. The government remains divided, with the Republicans still in control of the House and the Democrats still in control of the Senate. While historically bipartisan support for major tax increases or spending cuts in the US has been extremely rare—since 1990 there have been only two instances when a major tax increase or spending cut was approved by a divided government—we believe a compromise is both necessary and likely.

According to U.S. Congressional Budget Office (CBO) estimates, full implementation of the Budget Control Act of 2011—the so called fiscal cliff—would result in a net budget "savings" of $506 billion annually. The CBO estimates full implementation would result in a mild recession, with U.S. GDP growth declining 0.5% and the unemployment rate increasing to 9.0% in 2013.

In our view, full implementation will not take place. Rather we anticipate a compromise agreement that will result in approximately a third of the full savings and, consequently, less drag on economic growth, resulting in continued positive growth in 2013. In addition, we expect the debt ceiling to be raised in a timely manner so as to avoid a government shut down. This cooperative action should have a temporary calming effect on equity markets and set the stage for positive equity returns in 2013, based on continued corporate earnings growth at current projected levels. It should be noted that the effects of a compromise agreement or even the full effects of the fiscal cliff would not be felt immediately, but rather would transpire over time. This lag effect affords the President and the Congress some time to continue to pursue a longer-term agreement, for example a Simpson-Bowles type amendment, to set the US on a more sustainable fiscal path.

With respect to fixed income, we continue to expect low single digit returns over the coming years and maintain a preference for high quality corporate bonds over government obligations. Our confidence that a compromise will be reached means that we continue to prefer high quality, blue chip, dividend paying equities to fixed income.

We continue to monitor and evaluate this, and other events, and to assess conditions with the objectives and best interests of our clients in mind.■

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