

# Investment Update



December 2012

## The Election and its After “Math”

After spending more money than a small country’s GDP, the election results are in, with President Obama winning re-election to a second term. The Republicans control the House, while the Democrats control the Senate. After all of that work and all that spending, here we are: essentially back where we started.

To the untrained eye, the markets didn’t seem to like the election results. After all, the Dow quickly proceeded to fall 300 points on the day after the elections. A closer look, however, reveals some interesting information. Stock futures were relatively flat the morning after the election, signaling that the markets already may have discounted an Obama win (as indicated in last month’s *Update*), opening the day near where they had closed the night before. Even European markets were up prior to Wall Street’s open, but only temporarily. As the day progressed, bad news followed from Europe when German GDP was reported lower than expected and European markets then sold off about 2% on the day. U.S. markets proceeded to follow them lower as well. Since then, the market has ground its way back to its pre-election levels.

## A Need to Focus on the Task at “Hand”

You may be happy with the election results, disappointed or somewhere in between. I learned long ago, however, that in investment analysis (as in many other things) it is fruitless to entertain “should’ve, could’ve and would’ve” scenarios. For comparison’s sake only, let’s look at poker. When dealt a hand, it does little good to think about how to play cards you do not hold. This thinking only distracts from the task at hand, which is to properly play the cards you have.

Currently, most investors seem to be focused on only the ‘bad cards’ in the deck. Yet it is important to be watchful of the strong cards we hold as well.

Our domestic economy continues to grow, although slowly, helped by an improving housing market. A tremendous amount of cash sits on the sidelines, with \$2.5 trillion in money market funds, perhaps ready to enter the markets should more clarity be offered. Valuations also remain reasonable in the equity market, with the S&P 500 trading at 14X earnings, roughly the same valuation seen during the 2009 market lows. All of these factors provide cause for markets to move higher. Although they are often seen as the weaker part of the hand, in comparison to the bad cards commanding so much media attention today, these positive factors should not be overlooked or discounted.

## The Fear of Falling

With an expiration date of year end, the amount of focus the fiscal cliff is garnering is understandable. So, while we should keep all our cards in mind, let’s first discuss the one that is trumping all others.

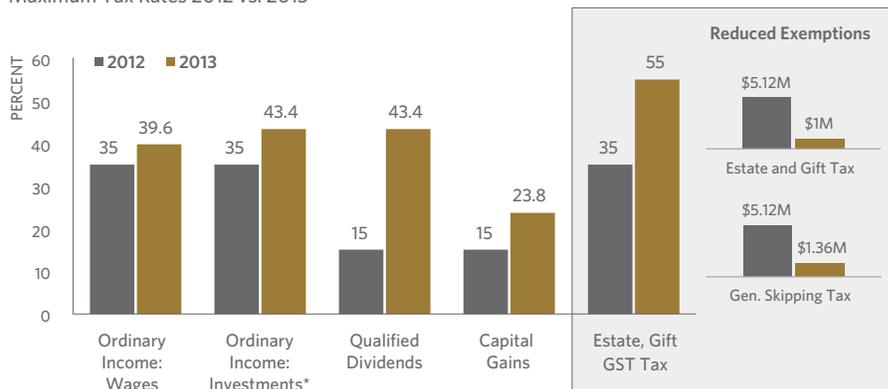
Exhibit 1 illustrates a “Thelma and Louise” version of the cliff. In black and white, it shows where current tax rates are scheduled to go if we do drive over the cliff. If this version were to occur, dividends and capital gains would be taxed at much higher rates.

If lawmakers fail to act, tax rates would increase by 3.5% of GDP (see Exhibit 2), which is by far the largest increase since the 1960s. The consequences of this increase most likely would be recessionary, particularly if the tax rates imposed by the fiscal cliff were to remain in force through most of 2013.

We continue to believe that this most dire scenario will not occur. Instead, a small bargain likely will be reached in Washington, as lawmakers are under significant pressure to do something. Also well within the realm of possibility is a ‘bungee jump’ situation, where the lame-duck Congress is unable to come to agreement. This would allow the U.S. to go over the cliff but with Congress promising to take action shortly after the New Year. In this scenario, markets could be very volatile in the short term, but rally if timely resolution is achieved.

## Exhibit 1—Steep Tax Increases in 2013

Maximum Tax Rates 2012 vs. 2013

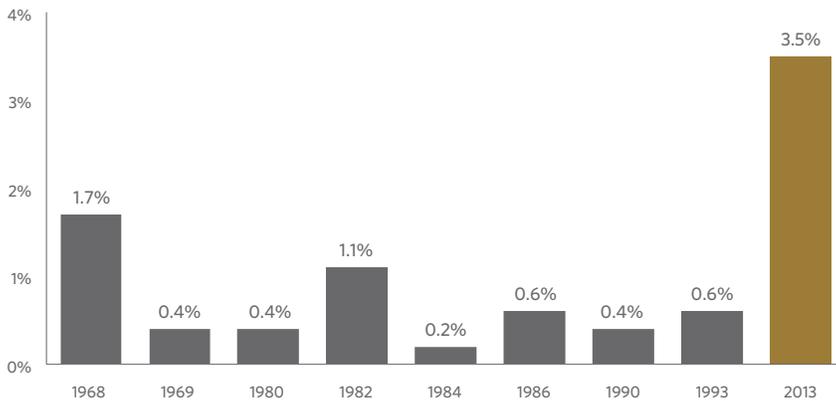


\*Excludes qualified dividends.

Note: The 2013 rates reflect the expiration of the Bush tax cuts and the 3.8% medicare tax on net investment income for certain high income taxpayers as well as the additional medicare payroll tax on employees. The rates summarized above do not take into consideration the increase in the marginal tax rates for higher income taxpayers due to the loss of the personal exemption, the loss of some itemized deduction and the deduction for self-employment tax.

## Exhibit 2—The Coming Fiscal Cliff Dwarfs Size of Any Prior Tax Increase

Size of Federal Tax Increases (Percent of Gross Domestic Product)



Source: StrategasRP.

With the cliff, the devil is in the details. A quick resolution, even if it were to come after December 31, would have very little impact on GDP next year. However, a longer fall, which would transpire if a resolution were not to be reached in early 2013, would have more material effects on next year's GDP.

So far, the markets seem to believe that Washington will find some common ground. Comparing the dividend rates of certain high-yielding equity sectors to bond yields, for instance, indicates that the markets are estimating that the tax rate on dividends will rise to 25%, up from the current rate of 15%. While this is certainly higher than the rate we all enjoy today, it is nowhere near the worst case, 43.4%, scenario shown in Exhibit 1. This 25% rate would make the dividend tax very similar to the projected capital gains rate, currently scheduled to increase to 23.8%.

### Benefit of the Doubt or Do Doubts Have Benefits?

The negative impact of the fiscal cliff will not wait until 2013. The truth is, it already is a problem. A recent pullback in the stock market, a slight sell-off in high yield bonds, and an increase in initial unemployment claims all are possible signs that businesses are slowing now. This hesitation will continue until businesses gain the clarity they need to make longer-term hiring and capital spending decisions. Add Hurricane Sandy to the mix and the Q4 2012 GDP may show significant and unexpected weakness.

In a way, these challenges may be good for markets over the longer term. If a compromise can be reached in Washington, companies would then have to hire and put in place the capital spending plans they had put on hold. The stock market might rally as well, as the high level of uncertainty would have been removed.

In the investment world, we often talk about the "wall of worry" that markets climb at this point of an economic cycle. History shows the markets' almost uncanny ability to push higher in spite of uncertainty or even bad news. Certainly, the election and the fiscal cliff both have been major building blocks in this wall of worry, yet markets have remained resilient. In spite of all these difficulties,

as of this writing, the S&P 500 is up approximately 14% YTD. To most, this is an unexpectedly high return, given the economic challenges the world has weathered for most of 2012.

### Getting to 'G'

Eventually, prosperity all comes down to 'G'—growth. While the fiscal cliff and the Eurozone dominate the headlines, it is important to remember that a growing world economy is the ultimate goal of each policy pursued. Growth will drive lower our unemployment rate, allow firms to increase their top line, enable governments to increase tax receipts and, when combined with higher productivity, ultimately increase our standard of living.

Assuming that a ride off the fiscal cliff is avoided, look for markets to turn their attention to some of the other cards—and uncertainties—we've been dealt. These include the expiration of Operation Twist (and maybe the launching of QE4), slowing growth in China, the Eurozone (especially to Greece and Spain) challenges and the continued high rate of unemployment.

Just as markets have nudged back to pre-election levels, they possess the potential to move higher as these other issues are resolved. The rally that began in 2009 retains an overly pessimistic view of the ultimate outcomes of many of the issues we now face. This low hurdle rate, combined with reasonable equity valuation levels and an economy that remains in muddle-through mode, may lead 2013 to be another year of markets that move stubbornly higher, albeit in a bumpy fashion, as we play the cards we are dealt in this slow-moving poker marathon.

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