US Budget Update: Partial Resolution to Fiscal Cliff Issues

As of January 2, 2013

On January 1, 2013, both the US Senate and House of Representatives passed the American Taxpayer Relief Act, which will avert a large part of the tax increases that otherwise would have taken effect immediately. The bill avoided tackling any spending and debt reduction issues, but we believe it marks a welcome start in addressing the country's budgetary issues—a far better situation than stepping off the fiscal cliff.

The new budget bill calls for a permanent return in the top marginal tax rate to 39.6% from the current rate of 35%. Essentially, this affects the income taxes for individuals earning more than $400,000 and married couples earning more than $450,000 (approximately the top 1% of households). The bill also reintroduces a phaseout of deductions for those top earners, and a slight increase on taxation of dividends and long-term capital gains.

All workers will now face the end of the temporarily lower payroll tax for Social Security: It will return to 6.2% from the temporary 4.2% that was instituted in response to the 2008–2009 credit crisis and subsequent recession. Another permanent tax measure in the bill will index the alternative minimum tax (AMT) to inflation, avoiding the potential tax hit this could have had on many middle-income households and eliminating the annual congressional ritual of passing short-term increases to the AMT threshold.

Removal of Taxation Uncertainty

One of the big positive effects of the bill is to eliminate the uncertainty concerning personal taxes. This has weighed heavily on consumer confidence, which declined sharply in December. And while this may have a beneficial short-term effect on the markets, the new bill still leaves many difficult issues on the negotiating table: particularly the heavy cuts in defense spending outlined in the Budget Control Act of 2011 and the need to address climbing costs of healthcare and other entitlement programs. These are problems that the incoming 113th Congress will have to wrestle with. We feel they will likely attack these issues in stages, with the next hurdle being the renegotiating of the debt-ceiling limit in late February or March.

In light of the new act, we are not making any revisions to our US gross domestic product (GDP) growth forecast of 2.7% for 2013. We are also not making any material changes to our equity and bond portfolios.

Equities Remain Attractive

We see the current budget developments as being positive for equities: While the markets may remain volatile for the next few months as political wrangling over entitlement reform and the debt ceiling continues, we believe this agreement removes much of the uncertainty and should enable investors to once again refocus on company fundamentals. For our bond portfolios, we continue to caution that returns will likely be modest, primarily due to the continued low-interest-rate environment and the potential that rates may rise in the future. On a positive note, the tax-free status of municipal bond income seems to have survived the threat of elimination or modification, removing another key uncertainty facing individuals.

For our clients with Dynamic Asset Allocation, we're moderately overweight stocks. We're taking this position because we see continued lower volatility in the equity markets and very attractive stock valuations. At the same time, we've emphasized risk control through greater international diversification (since non-US stocks have more attractive valuations); a modest amount of downside protection on a small portion of our equities; and the substitution of real assets as well as investment-grade and high-yield bonds for a portion of our equity exposure, providing further diversification.

As well, we will continue to evaluate the impact of these latest changes in personal taxation to our tax management strategies in client portfolios and make modifications as appropriate.

For more information, please read our "US Economic Outlook" from our Chief Economist, Joseph G. Carson, which we will publish this Friday, January 4.

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