**MARKET INSIGHTS**

# Progress on the road to fiscal stability

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## Introduction

In the early hours of 1 January 2013, the US Senate approved a fiscal cliff package by a vote of 89 to 9 and sent it to the House of Representatives, who subsequently passed the package as New Year's Day came to a close by a vote of 257 to 167. While this last-minute resolution was undoubtedly a better outcome than if Congress had allowed the economy to go over the fiscal cliff, many long-term issues, particularly those related to entitlement spending, still need to be addressed. With Washington as polarised as it has been since the American Civil War, future negotiations will be difficult and markets could become turbulent. However, it is imperative that the US gets its finances on a more sustainable path, and it appears that the steps taken in Washington on New Year's Day, if accompanied by serious entitlement reform, will be sufficient to reduce the deficit and bring the budget closer to balance at a roughly appropriate pace.

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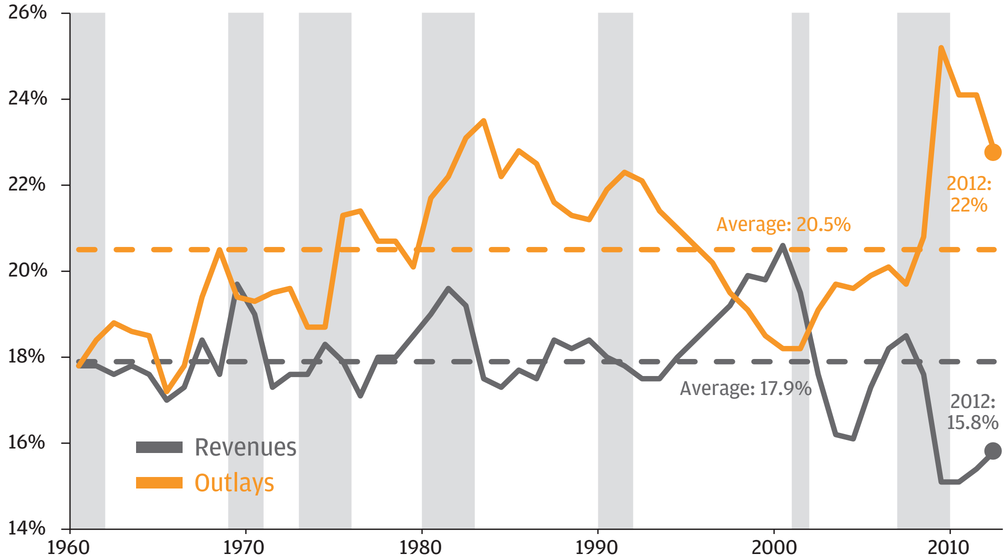
## An unbalanced budget

Although the US briefly ran a budget surplus in the late 1990s and early 2000s, federal finances in the US have been characterised by a chronic spending problem for quite some time. As shown in **Chart 1**, federal spending has exceeded revenues in 47 out of 53 years since 1960, and particularly over the last decade.

CHART 1 | FEDERAL OUTLAYS AND RECEIPTS

**1960 – 2012, % OF GDP**




Sources: BEA, OMB, J.P. Morgan Asset Management. Data as at 3 January 13.

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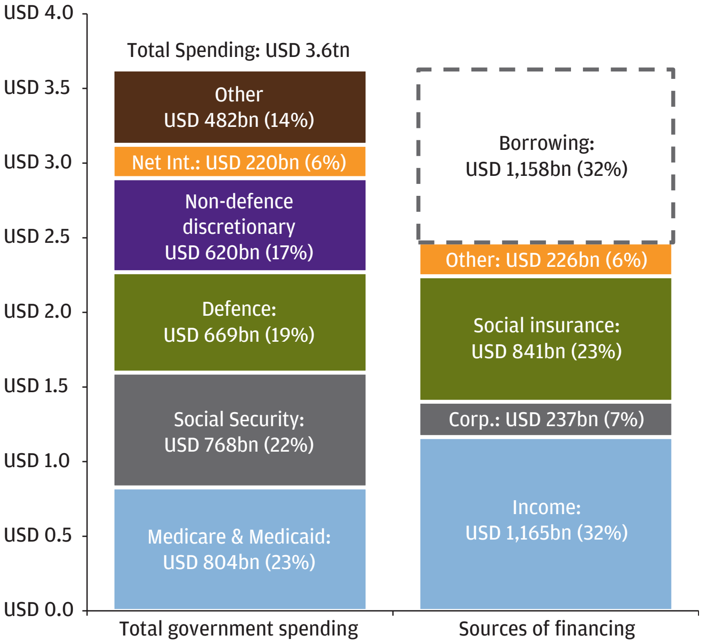
This imbalance has been a function of both too much spending and not enough revenue, and a viable, long-term solution will require outlays and revenues to be brought in line with one another. **Chart 2** looks at the 2012 federal budget; the US government borrows approximately 32% of what it spends, highlighting the difficulty in achieving a balanced budget by solely cutting spending or increasing revenues.

CHART 2 | THE 2012 FEDERAL BUDGET

**CBO baseline forecast, trillions USD**




2012 federal budget is based on the CBO's August 2012 baseline scenario. Revenue breakout is based on 2012 tax revenue estimates from the Office of Management and Budget.

Sources: OMB, CBO, J.P. Morgan Asset Management. Data as at 3 January 2013

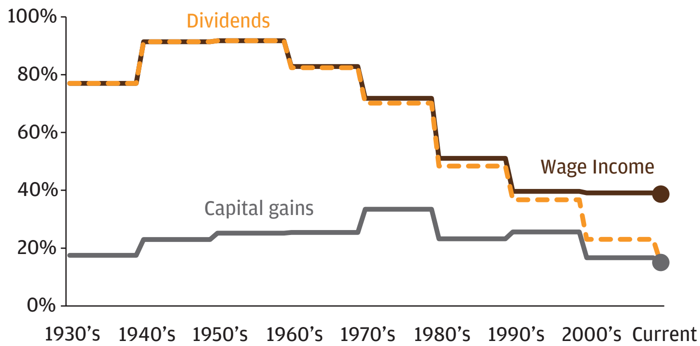
A more balanced budget will require broad-based spending cuts as well as higher tax revenue. Although allowing the economy to go over the fiscal cliff would have been a significant step towards a balanced budget, it would have simultaneously tipped the US economy into recession.

The package passed on New Year's Day will not reduce the deficit as quickly as allowing tax cuts to expire and automatic spending cuts to kick in, but a gradual path to deficit reduction is more appropriate given the current environment of moderate economic growth.

# Details of the deal

The deal that was passed affects both revenue and spending. On the revenue front, the Bush tax cuts were extended for individuals with income less than USD 400,000 and for households with income less than USD 450,000; above these thresholds, the marginal income tax rate will rise from 35% to 39.6%, and taxes on dividends and capital gains will increase to 23.8%[1]. While some have maintained that an increase in taxes on capital gains and dividends would negatively impact the capital markets, it is important to note that, even after this increase, both remain below their historical highs. This is particularly true for dividends, which until 2001 were taxed at the same rate as wage income (and at an average top marginal rate of 65% since 1930).

CHART 3 | HISTORICAL AVERAGE MAXIMUM TAX RATES BY DECADE




Sources: IRS, J.P. Morgan Asset Management. Data as at 3 January 2013.

In addition, the Alternative Minimum Tax (AMT) has been permanently indexed for inflation, the top estate and gift tax rate has been increased from 35% to 40% for estates greater than USD 5m and will also be indexed for inflation, and a number of other tax breaks were extended for 2013. However, one significant aspect of the bill has to do with the payroll tax cut. In 2011 and 2012, the payroll tax cut reduced the employee's share of Social Security taxes by 2%, but this was allowed to expire as part of the New Year's package. The expiration of the payroll tax cut will cost taxpayers around USD 117 billion in 2013, while the other tax increases will cost taxpayers less than half as much. As a result, this increase in payroll taxes will be the most damaging, as consumer spending on basic goods and services such as groceries, clothes and petrol will likely take a hit due to lower take-home pay. The major changes in tax policy are summarised in **Chart 4**.

[1] Taxpayers with modified adjusted gross income above USD 200,000 for individuals and USD 250,000 for households will be subject to an 18.8% tax on capital gains and qualified dividends. Non-qualified dividends will continue to be taxed at the same rate as ordinary income.



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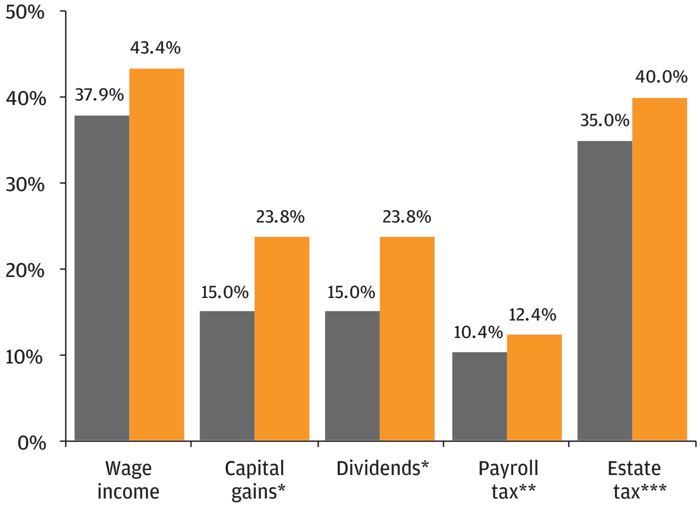
### CHART 4 | POTENTIAL TAX RATE CHANGES

2012 and 2013 maximum federal tax rates under current law




Sources: IRS, The Tax Foundation, J.P. Morgan Asset Management. Tax rates based on maximum US individual income tax. Wage income tax rates include employer and employee contributions to the Medicare tax.

*Includes recently enacted healthcare tax of 3.8%.

**In 2011 and 2012, the payroll tax cut reduced the employee's share of Social Security taxes by 2%. This was allowed to expire for 2013. Rates shown include both employer and employee contributions to the payroll tax.

***For 2013, the estate tax exemption amount remained at USD 5.12m

Data as at 3 January 2013.

Turning to spending, federal extended unemployment benefits and the 'Doc Fix', which prevents a 27% cut to doctors' Medicare reimbursements, were both extended through the end of 2013. However, there was no deal on replacing the sequester[2] or raising the debt ceiling, which Washington will now have to deal with during the first quarter. The automatic spending cuts of USD 109 billion have been delayed until 1 March 2013, which, given that the new members of Congress were seated on 3 January 2013, gives President Obama less than 60 days to deal with this issue. The agreed combination of revenue increases should help bring down the deficit gradually without tipping the economy into recession, and although some may view Congress as having kicked the can down the road on the spending issue, this deal actually makes a good deal of progress in reducing the deficit at a sufficient pace. However, the issue of long-term entitlement spending remains, and it would not be surprising to see markets become volatile as the deadline for dealing with the automatic spending cuts and the debt ceiling approaches.

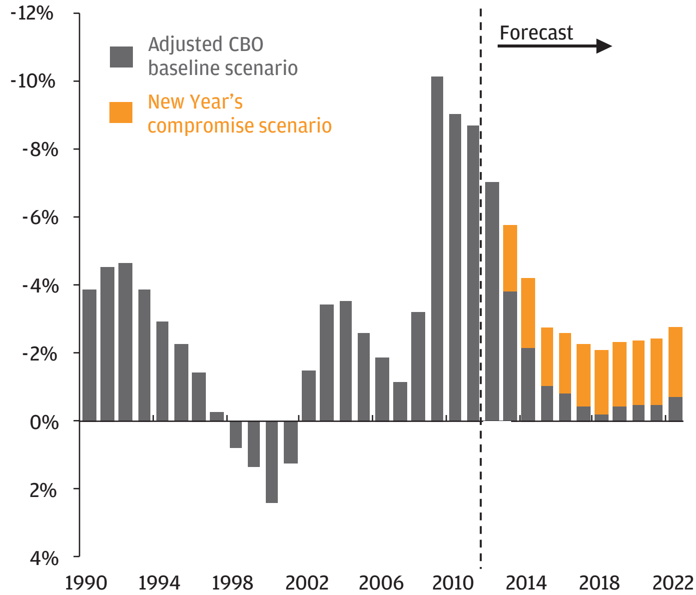
## Implications for the debt and deficit

Although this new plan should successfully reduce the deficit over the coming years, the recent vote may actually have been too large a step in the right direction. As shown in **Charts 5 & 6** and **Table 1**, these tax increases and spending cuts could cut the deficit from 7.0% of GDP in calendar year 2012 to roughly 5.5% in calendar year 2013, and while this is not quite a fiscal cliff, it is still a painful fiscal ledge.

[2] The sequester is a package of automatic spending cuts agreed to as a part of the August 2011 Budget Control Act (BCA). The cuts total about USD 1.2 trillion and were scheduled to begin in 2013 and end in 2021, evenly distributed over the nine years. The sequester cuts would have been evenly divided between defence spending and discretionary domestic spending.

### CHART 5 | FEDERAL BUDGET SURPLUS/DEFICIT

% OF GDP, 1990 – 2022




2012 numbers are actuals. Years shown are fiscal years (1 October to 30 September). Deficit and debt scenarios are based on CBO budget forecasts from August 2012 and the CBO cost estimate for the American Taxpayer Relief Act, as passed by the Senate on 1 January 2013.

Sources: US Treasury, BEA, CBO, J.P. Morgan Asset Management. Data as at 3 January 2013.

### CHART 6 | FEDERAL NET DEBT (ACCUMULATED DEFICITS)

% OF GDP, 1990 – 2022

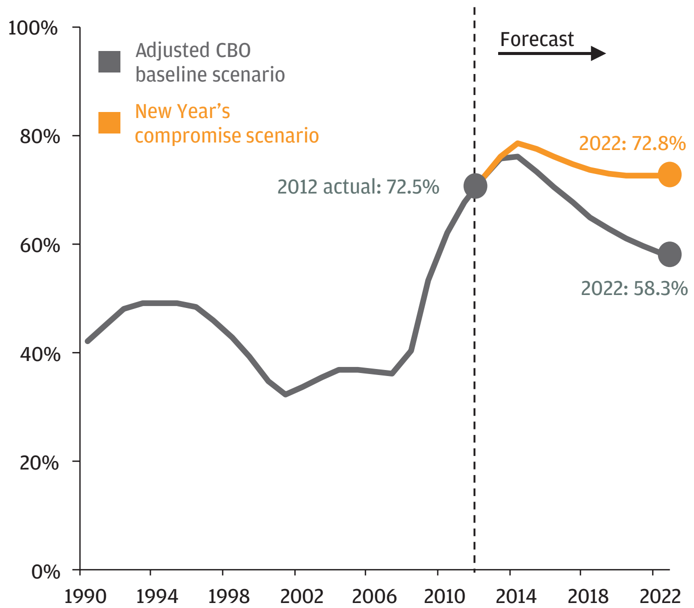



Chart displays federal surplus/deficit (revenues – outlays). Federal net debt comprises all financial liabilities of the Federal government (gross debt) minus all intra-government holdings as assets.

Sources: US Treasury, BEA, CBO, J.P. Morgan Asset Management. Data as at 3 January 2013.



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**TABLE 1** | DETAILS OF THE NEW YEAR'S COMPROMISE

| The New Year's compromise | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Fiscal year** | **2012** | **2013** | **2014** | **2015** | **2016** | **2017** | **2018** | **2019** | **2020** | **2021** | **2022** |
| **CBO baseline scenario deficit, USD billion** | -1,128 | -641 | -387 | -213 | -186 | -123 | -79 | -130 | -142 | -144 | -213 |
| **Adjustments:** | | | | | | | | | | | |
| Updated CBO baseline scenario deficit | -1,090 | -622 | -368 | -194 | -167 | -104 | -60 | -111 | -123 | -125 | -194 |
| CBO estimate of cost of H.R. 8 | 0 | -330 | -354 | -311 | -340 | -371 | -405 | -416 | -448 | -483 | -515 |
| Revised nominal GDP | 15,549 | 16,196 | 16,751 | 17,757 | 18,922 | 20,077 | 21,190 | 22,186 | 23,196 | 24,213 | 25,256 |
| **Revised Deficit** | -1,090 | -952 | -722 | -505 | -507 | -475 | -465 | -526 | -571 | -608 | -709 |
| **% GDP** | -7.0% | -5.9% | -4.3% | -2.8% | -2.7% | -2.4% | -2.2% | -2.4% | -2.5% | -2.5% | -2.8% |

* The 2012 deficit came in USD 38 billion lower than originally projected, and we assume that half of this persists throughout the forecast horizon.
Sources: CBO, BEA, US Treasury, J.P. Morgan Asset Management.
Data as at 3 January 2013.

It seems unlikely that this deal will be fatal for the expansion, but it could cause economic growth to slow to nearly zero in the first half of 2013. However, stronger consumer and corporate balance sheets along with significant pent-up demand, particularly in the cyclical auto and homebuilding sectors, should allow growth to accelerate in the second half of the year. As economic growth strengthens, revenues increase and spending is brought under control, the deficit should eventually fall below 4.0% of GDP, allowing the debt/GDP ratio to fall and federal finances to stabilise.

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## Investment implications

With debates over the sequester and debt ceiling still ahead, it will be important for investors to remain balanced. Equities moved higher in the wake of this deal, but markets could become volatile as the remaining issues come into focus over the coming months. Republicans have little appetite for future tax increases, and President Obama has said he will not negotiate with Republicans over raising the debt ceiling. As a result, it would not be surprising to see the same sort of political food fight we saw surrounding the fiscal cliff prolong debates over spending and the debt ceiling until the eleventh hour. Given these unresolved issues, a balanced and diversified portfolio of stocks, bonds ands alternatives should help protect portfolios if markets become volatile. That said, although the process has been obnoxious and the final product is somewhat distasteful, the steps taken on New Year's Day are a clear sign of progress, and the pace at which the deficit is now expected to decline should be sufficient to help put our federal finances on a more sustainable path.


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