Beyond the Election Noise and the Fiscal Cliff

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Game Plan

Through all the noise, we don't expect real results on the Fiscal Cliff negotiations until late December

We see three possible outcomes which the market perceives but within the most likely outcome we see 3 stages.

- The Punt: A Deal before year end which allows many tax cuts to expire but punts the heavy lifting of a grand bargain (most likely)
- Go Off the Cliff: $660 billion tax increase + spending cuts = 4.6% hit to GDP, hard recession (not likely)
- A mega deal Grand Bargain before year end (will not happen)

3 Stages of the Punt

1. We get a deal December 20th – 22nd
- $220 billion of expiring tax increases and spending cuts, 1.4% of US GDP, a hit to GDP Growth of 1%

2. Deal Reached between December 26th – 31st with Same Terms

3. We Bounce off the Cliff Lehman Style and Get a Quick Deal in January when the House and Senate come back into Session

There's not enough time between now and year end for a "grand bargain" in the Fiscal Cliff drama but there is time for a $170-$250bln short term deal, again after Dec 20th, best case

Rating Agency downgrade chance increases with a punt, impact on other credits is the biggest factor, US IGs, Sovereigns

ACG Analytics believes that a deal which will increase taxes (and fiscal drag), blunts the sequester, and formalizes a framework and expedited process for tax and entitlement reform will be completed before the end of the year, though it will not be a smooth process, likely producing increased market volatility right up until the deal becomes law.

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Obama and Boehner the First Meeting, a Deal and Head Fakes

“Mr. Speaker, Incomes above $250k will be taxes at 39.6% and I’m proposing a 10% surtax on incomes above $1 million”

“Mr. President, we’re not giving on the tax rate but are willing to talk on deductions and exemptions”

Republicans in Congress have thus far appeared to be flexible, supporting increased revenues (thought not tax rate increases) as their initial offer. It is important to note that one person's revenue is not another's and ACG Analytics believes that the White House and Congressional Democrats will not be satisfied with only caps on deductions and exemptions, or means testing the use of deductions and exemptions (both of which lead to higher average tax rates, NOT higher marginal tax rates). The President has usually shied away from using the phrase "tax rates," but he has made it clear that he insists upon the "wealthiest Americans paying more in taxes."

Possible Deal Territory

Means Testing on Dividends
Cap on Deductions and Exemptions at $75k

Watch Out for Head Fakes

Both sides when away from the table will use their contacts in the press to make their case and make the other side look bad

Expect several deal moments to come and go, increasing market vol substantially

Full negotiations will not begin in earnest until the week after the Thanksgiving recess. In the meantime, the White House will convene three separate meetings on the fiscal cliff this week with: progressive non-profit leaders and labor union officials; business leaders (although Wall Street firms are conspicuously absent from the list of attendees); and Republican and Democratic Congressional leaders.

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Open Questions?

- The big issue is the relationship of tax increases to spending cuts. France's 2/3 Taxes to 1/3 Spending Cuts already impacting their economy, we have fresh evidence from Europe of the GDP destructive powers of tax increases on a weak economy
- Real problem, NO ONE is talking about is the US has Never increased taxes w/out a real Fiscal & Monetary policy buffer, QE is a squirt gun vs. Tax increases
- Fair Fight? The stimulus of QE vs the deflationary impact of Fiscal Cliff 1% of GDP economic contraction & Europe's slowdown, where's the strongest multiplier?
- "I don't think the Fed can take additional action that would be powerful enough to address the complete failure to address the fiscal cliff.“ St. Louis Fed chief James Bullard
- Entitlement Cliff? Since 2008, Medicaid has grown from 46.9 recipients to 56 million, disability beneficiaries have from 7.5 to 8.8 million, lot of Florida votes here...
- Letting the Bush tax cuts expire for those with incomes > $250k, only generates $60 billion in new revenue, 2011 Medicare costs were $550 billion
- US spent $30 billion a year on unemployment benefits in 2007, $155 bln in 2010, $98 bln this year, Fiscal Cliff cuts this by $30 billion
- Extension of the debt ceiling won’t be a major bargaining chip for House Republicans in the Fiscal Cliff negotiations until Q1 2013 issue, more GOP power then in this game.
- Visibility Play Looming Massive Positive: $1.8 trillion on US corporate balance sheets, CFOs will put to work once the Fiscal Cliff is put to bed, a positive catalyst in a negative news sea, but do we need a Grand Bargain or a Punt?
- Pelosi replacement in the next 45 days?
- Fiscal Cliff Deal impact on Boehner reflection to speaker, may a coup develop if he strikes a deal?

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Bottom Line

- The bottom line is that the Republicans' opening offer is already an admission that revenues must increase and this stems from the outcome of the elections. Look for further capitulations from House and Senate Republicans on revenues; however, any compromise will still need to be passed through the House, likely requiring a large number of Democratic votes to offset Republican opposition.
- ACG Analytics also expects that Boehner will not be undermined on his right flank by Majority Leader Eric Cantor (R-VA) because Cantor is adamant that the sequester needs to be blunted due to its effects on his home state's economy, as well as the fact that the next two years (with an emboldened Democratic President and Senate Majority Leader) is not the ideal time for Cantor to make an aggressive attempt at becoming Speaker.
- Although a “punt” interim deal bridging the fiscal cliff will remove some market uncertainty and will serve as a short-term positive catalyst for the markets, longer-term comprehensive corporate and individual tax reform - as well as potential entitlement reform - will not occur until well into 2013 at the earliest. This remaining uncertainty could leave the markets with a hangover following any new year's celebration of an interim fiscal cliff compromise.
- The public meetings and statements are an attempt by the Obama Administration to conduct negotiations in the public eye and to continue its momentum from the successful campaign season. Obama's strategy is to box in Congressional Republicans with the court of public opinion (as well as the financial markets) in order to secure a deal more favorable to the White House and to ensure that the country does not go over the fiscal cliff.

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Details of the Deal

- **With these dynamics in mind, please find below the contours of <u>ACG's base case scenario for a deal during the lame duck session of Congress</u>:**

  - Tax rate increase on $1MM+ income for next year pending comprehensive tax reform in 2013
  - Otherwise, Bush tax cuts extended for one year
  - Additional revenue comes from closing "loopholes," including carried interest, some oil/gas credits, limits on individual deductions and exemptions, and other politically attractive ones to Dem base (corporate jets, etc.)
  - Increased revenues will allow sequestration to be averted for 2013, but likely replaced with new fiscal triggers pending budgetary deal reached by year end 2013
  - AMT is patched
  - Tax extenders (R&D tax credit, wind production credit, etc.) extended
  - Sustainable Growth Rate of Medicare or "Doc fix" extended at least 3-6 months
  - Payroll tax holiday EXPIRES
  - Extended unemployment insurance PHASED OUT OR EXPIRES
  - Some form of framework and expedited consideration process is established for 2013 re: comprehensive tax reform, entitlement reform and deficit reduction
  - Unclear whether debt ceiling increase is included in year-end deal although the White House is likely to push for its inclusion

- Among the payroll tax holiday expiration, extended unemployment insurance being phased out/expiring, and increased tax revenues, we predict that there will be an approximately $200 billion in fiscal drag for 2013. At the same time, ACG Analytics expects that there will be at least a short-term boost to confidence and certainty from this deal--once it is finally passed.

- In terms of timing of final passage, we believe that it will take place before January, with the most likely scenario being final votes before Christmas, though there is a possibility that it could slip until after Christmas, particularly if Boehner encounters strong resistance from rank and file members of his caucus. Should a compromise be unsuccessful before December 31, then we expect Congress will pass the legislation in January, with public outrage and significant market losses quickly forcing a compromise. However, we only view the chance of passage slipping past year end at this time being 15-20%.

Lessons from the 1968-9 Great Society Take Hike

There has not been a single year since 1970 when an increase in income tax revenue ran even as high as 1%, Fiscal Cliff = 2.7%

The 1968-9 tax hike is the nearest historical comp at 2.1% of Nominal GDP

S&P 500 Lost 35% from the Spring of 1969 into 1970.

Question of the week, with the S&P 500 off 7% from recent highs, how much of a Fiscal Cliff GDP economic hit to earnings slowdown has it priced in?

Financials, going into the Election were outperforming the S&P 500 by 250bps, now even, SPY off 6.5% from highs, XLF off 6.5%. Banks sell the rallies near term in the face of Dodd Frank uncertainty.

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Treasuries have broken out of a Multi Month Uptrend in Yield

The 2011 Debt Ceiling, US Credit Rating Downgrade crisis led to a near 160 bps rally in US 10 Year Treasuries. Europe helped

So far this round, we have rallied 27bps

US 10 year Treasury this morning touches lowest yield since September 5, President Obama & D.C. gridlock formation is bond friendly

Last week's worst performing sovereign CDS. Bad news: US 5 Year CDS is out 40% since Oct 25th at 42bps, good news; it was 60bps during the 2011 downgrade debt ceiling drama.

US Treasuries most overbought since July, are a short term sale here but buy the dips in bond price on a fiscal cliff punt

Volatility is Here to Stay for the Next 6 Weeks

The negotiations remain very fluid at this time, though the opening positions of each side have been widely reported. The White House and Democratic Congressional Leaders want an increase in marginal income tax rates for the "wealthiest Americans" to increase.

Some Democrats have used the $250,000 marker, but others have in the past used $1 million and above. The majority of the time, both the White House and Congressional Democrats use the phrase "wealthiest Americans" which is an attempt to prevent them from being boxed in, should the final deal not include higher marginal tax rates on households making over $250,000.

The starting point for Republican Leadership, or at least for Speaker Boehner, is that increases in tax revenue are on the table, which would come from some type of limitation on deductions and exemptions in both business and personal taxation.

These limitations can take several forms: a hard cap on the ability of the wealthiest individuals to use these tax breaks (they are available up to a hard dollar cap, such as $50,000), or the use of means testing to determine eligibility for deductions and exemptions (such as only households making under $250,000 are eligible), or a combination of the two which uses means testing and a hard cap in tandem to ensure maximum revenue recovery and that the deductions and exemptions remain progressive.

Housing: Home Builder Pain

ACG Analytics believes that there are several real risks for mortgage investors in a post-election environment, nearly all of which are non-legislative. Although some of these risks are reappearing and others have received recent media attention, we believe that it is important for investors to understand the political dynamics behind these risks and how they are viewed within the Beltway.

The largest risk is one that had been discounted previously -- that President Obama recess appoints a new candidate to head the Federal Housing Finance Agency (FHFA), to replace Acting Director Ed DeMarco. Any new appointee could potentially alter the efforts of the government sponsored enterprises (GSEs) to modify mortgages, as well as the agency's plans for streamlining and modernizing the housing finance system writ large. Other risks include a disruption in the mortgage origination and GSE securitization markets through a resurgence of interest in using eminent domain, and Congressional GSE reform efforts.

The Obama administration will now reconsider numerous actions that it can take without Congressional approval in order to advance their second-term agenda and create a more improved housing legacy for the President. The potential to govern the housing finance sector through administrative fiat without Congressional due process creates a hazardous environment for investors, particularly related to the timing of any announcements.

Obama Winners: Wind Power, Solar Power, and Biofuels
Coal names are off 7% Since Election Day – Biofuels off 4%, Wind off 2.56%

If there is a deal to address the budget deficit or the introduction of a tax overhaul, where oil and gas industry tax provisions, the gas tax, and the wind production tax credit could all come into play.

US coal exports to Europe have jumped 31.5% this year, due to cost advantage over Russia gas. Will this hold?

The Obama Administration has frequently stated its support for efforts to develop renewable energy sources as well as the development of natural gas and oil production while ensuring it is environmentally safe.

Certain oil and gas industry tax benefits could be at risk during any lame duck compromise on the fiscal cliff.

Focus of the 2nd term Administration under this scenario will be on developing renewable energy sources and clean energy jobs, reiterating the "all-of-the-above" strategy that he has referenced – to not only develop domestic oil and gas, but to further develop wind power, solar power, and biofuels.

The President's energy advisor, Heather Zichal, recently said that if Obama were to win a second term, that it would remain a "big issue" to work with Congress on clean energy policy.

With a 2nd term, we would be more likely to see a push by the Administration for tax incentives for the research, production, and use of clean energy technologies, such as an extension of the wind production tax credit (PTC).

Who is Ron Wyden (D-OR) and Why Should You Care?

The Administration has proposed expanding select tax incentives for commercial-building energy efficiency, extending incentives to promote manufacturing of advanced energy technologies, extending certain renewable energy incentives, and modifying incentives for alternative technology vehicles.

Oil and natural gas production growth is a give in the Administration's 2nd term. However, look for Democrats to push for an end to some oil and gas industry tax benefits as part of a potential fiscal cliff compromise, as well as any ensuing comprehensive tax reform process.

Though approval for the Keystone XL pipeline was delayed last fall, it is likely to be eventually approved and fully constructed in a second-term Obama Administration.

Senate Energy and Natural Resources Committee Chairman Jeff Bingaman (D-NM), is retiring and Senator Ron Wyden (D-OR) will be the new Chairman of the Committee, should Democrats continue to hold the majority.

Wyden would be the **first chairman of the Committee in more than 20 years from a state that does not produce fossil fuels** and has typically been more skeptical of the fossil fuel industry and of nuclear energy. Instead, Oregon focuses a lot of attention on renewable energy, specifically hydropower and wind.

Wyden has also expressed concern over the exportation of liquefied natural gas based on the fear of raising costs to American consumers, though over the August recess he visited the Committee's Ranking Republican, Senator Lisa Murkowski (R-AK), in her home state of Alaska to learn more about the issue.

Rep. Fred Upton (R-MI) is expected to continue his role as the Chairman of the House Energy and Commerce Committee where he has led the panel to work on legislation to limit the EPA's power and remove barriers to domestic energy production.

Secretary of Energy Steven Chu is not expected to return for a second term. One potential replacement is former Michigan Governor Jennifer Granholm (D). She has been a strong proponent for renewable energy-based jobs, particularly as a means of diversifying jobs away from the automotive sector in her home state.

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Lessons from the S&P vs VIX Futures vs 2 Month vs. 8 Month UX2-UX8 Spread

The VIX term structure which is effectively derived from the volatility term structure of SPX options, offers an insight into the market's expectation of volatility of the S&P 500 over time in response to market conditions.

In 2009, when the equity rally began, the Vix term structure shifted from backwardation (downward sloping front month higher than back month maturity) to contago (upward sloping) .

The measure of the term structure we use here is the spread between the 2-month and 8-month future UX2-UX8 (currently Dec12 18.80% vs June13 23.6%). It tends to steepen ahead of and during rallies (Oct 2011 to march 2012 and June-sep 2012) and flatten prior to and during selloffs (past 2 months).

After hitting a 2-year high of 9% in mid September , the spread has dropped as low as 3.8% last week and has been a leading indicator of the recent correction in SPX.

Bottom Line: As the Blue line is in decline, it's an expression of rising demand for 2 month VIX futures vs. 8 month, this tells you that players in the market are more concerned about near term risk. This has been one of my most reliable of my 17 Lehman systemic risk indicators.

Euro Currency Volatility and the Vix

Euro Currency Volatility is **unusually** moving in a opposite direction from the VIX

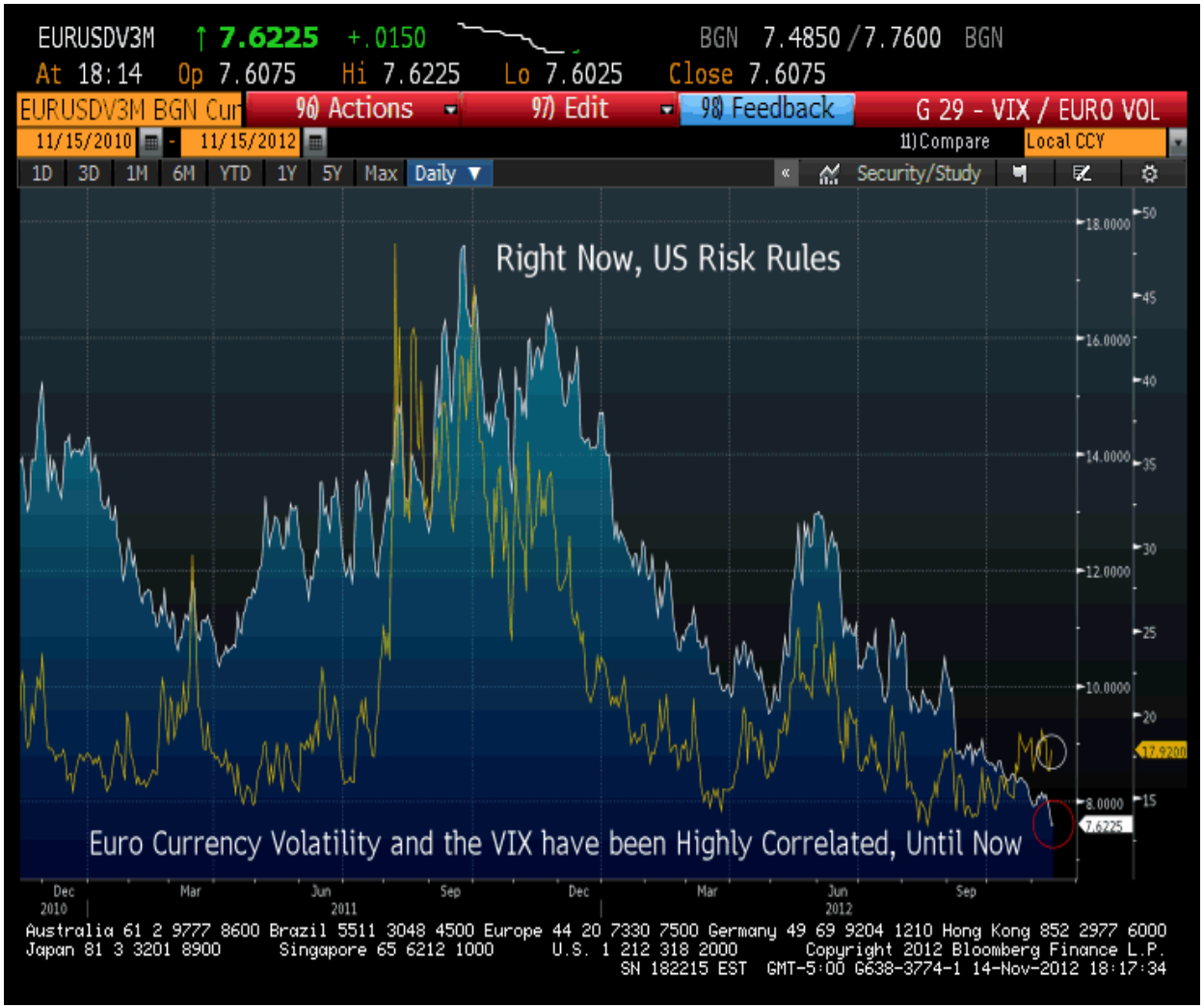
These two indicators have been highly correlated for much of the last 3 years

Euro Currency vol looks attractive

This is more of a statement of USA systemic risk surpassing Europe for the first time in the last 36 months

The ECB has also adopted its most aggressive easing stance to date. The announcement of the OMT has kept European credit markets relatively calm and helped iTraxx Main outperform CDX IG.

So European corporate credits have been outperforming US corporate since Oct 15th, this time last year they were underperforming by 65bps. Even with 4 countries in Recession, better performance?



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Dividend Stocks are Underperforming Since Election Day, but will they Get a QE Bounce?

Dividend names underperforming since election day.

Deal on Capital gains 22-25%? Most likely we end up with a low 20s deal on capital gains while dividends move from 15% tax to as high as 39.6% ordinary income. Overtime this will increase demand for companies that reinvest earnings, growth stocks rather than dividend payers.

In 2003, when the Bush tax cuts lowered the tax on dividends to 15%, dividend names like utilities rallied then sold off, we may see a similar effect here in reverse

Operation Twist Ends in December, Look for the Fed to add $45 billion of New QE.

Fed's Bullard expects the U.S. gross domestic product to accelerate to 3.5% by next year, and what is currently a 7.9% unemployment rate should fall gradually to 7.2% by the end of 2013.

Gold Shines, with Power Doves and Keynesians in Firm Control of the Fed

Gold was more than 5% off it's recent highs since the Romney victory in the first debate, she's up 2.4% since election day.

Federal Reserve Chairman Ben Bernanke's term expires in 2013, and ACG expects a nomination for his replacement sometime during the spring or summer.

Candidates include current Vice Chair Janet Yellen, TIAA-CREF CEO and former Vice Chair Roger Ferguson, and Donald Kohn. Choosing someone such as Ferguson or Kohn would allow the President to demonstrate that he is able to go outside his inner circle and could also help to reassure market participants.

Yellen would likely have a difficult confirmation battle, due to what are her perceived "dovish" views on inflation.

This week Yellen backed a proposal to link the Fed's zero interest-rate policy to progress toward meeting its goals for inflation and employment rather than to a calendar date.

"The Committee might eliminate the calendar date entirely and replace it with guidance on the economic conditions that would need to prevail before liftoff of the federal funds rate might be judged appropriate," Yellen said.

New Players Treasury OMB

Successfully disposing of the near-term aspects of the tax and deficit-related issues in the first few months of his second term are critical to the President's ability to advance his other priorities. For this reason, we expect that he will appoint current **White House Chief of Staff Jack Lew as Treasury Secretary** and de facto chief negotiator with the Congress. Other contenders include former Clinton Chief of Staff Erskine Bowles and BlackRock's Larry Fink.

We also expect that National Economic Council (NEC) Director **Gene Sperling will move over to the Office of Management and Budget**, with his deputy, Jason Furman, taking the helm at the NEC. Alternatives to Sperling at OMB include Congressional Budget Office Director Doug Elmendorf, and Jeff Zients, who is currently the Deputy Director for Management.

Each of these choices reflect the President's preference to surround himself with individuals who reflect his worldview and what he believes should be the priorities of a second administration. The few times where an outsider has been appointed to a high-profile position, such as Bill Daley as Chief of Staff, the results have been lackluster. Reshuffling existing figures ensures that there is no real "transition" period and building the President's legacy can begin immediately.
Additional economic appointees are likely to include Shaun Donovan remaining at the Department of Housing and Urban Development (HUD), Gary Gensler either staying at the Commodity Futures Trading Commission or moving over to the Securities and Exchange Commission to replace Mary Schapiro, and for his Council of Economic Advisors Chairman to remain Alan Krueger or replacing him with Peter Diamond (whose Federal Reserve Board nomination was blocked), or Harvard professors David Cutler or Jeffrey Liebman.

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New Players at the Fed, FHFA, HSS, Education Energy and EPA

FED, FHFA

Two critical positions will not be filled immediately, but are worth mentioning. Director of the Federal Housing Finance Agency (FHFA) and the Chairman of the Board of Governors of the Federal Reserve.

Ed DeMarco has been Acting FHFA Director since 2009 and ACG Analytics believes that there is a real possibility he will be replaced in 2013. Obama could either use a recess appointment, or if Senate Majority Leader Harry Reid (D-NV) decides to use the "nuclear option" by reducing the votes needed to end a filibuster from 60 to 55, then the Democrats could likely move a confirmation through the Senate without worrying about Republican resistance as it appears the Democrats and Independents in the Senate will now hold exactly 55 seats. ACG Analytics believes Obama sees salvaging his legacy in regard to assisting distressed homeowners as a high priority (GSE reform is less of a priority than helping struggling homeowners). A tell-tale sign that Obama is willing to expend political capital on this issue will be the nomination of a new FHFA Director in the coming months.

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HHS, Education

Shifting out of the economic appointments, we believe that Kathleen Sebelius will remain at the Department of Health and Human Services in order to oversee the full implementation of the Affordable Care Act and Arne Duncan is expected to remain at the Department of Education to oversee reauthorization of the Higher Education Act.

Energy, Interior

For the Department of Energy, we expect that Michigan Governor Jennifer Granholm will get the nod to become Secretary and continue to promote the President's clean energy agenda in the context of new jobs and shifting manufacturing and other union-dominated laboring jobs into these new sectors.

We think that Interior Secretary Salazar will remain in place at least for the start of the President's term, although changes at the Environmental Protection Agency (EPA) remain an open question. ACG Analytics believes that whoever eventually takes over at EPA will be in ideological lockstep with the Administration and will vigorously implement the President's priorities in this area.

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