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Special Interest Articles:

Fiscal Cliff Diving

By Christopher W. Beale, CFP®

About three years ago I recall my then 15 year old son, Jonathan asking if I had ever been to the Portland Quarry in Portland, CT to dive off a cliff into the water below. He had been there several times with friends, family and even on a Wallingford Park and Recreation outing. He enthusiastically described how fun it was to jump off the cliffs at different heights of 10, 20, 30 feet into the cool, deep waters down below. I must admit, the conversation brought back fond memories of my times at the Quarry when I was his age. Hot summer days, swimming in the cool water, and the thrilling exhilaration of the jumps.

The thrills from jumping off the cliffs come in large part from anticipation and uncertainty. "How would I feel "flying" through the air? How long would I be "flying"? How long would I be underwater before resurfacing? How much would it hurt?"

Of course, economically speaking, uncertainty is not a positive term. Before I discuss what uncertainty costs our economy, let me first explain the pending fiscal cliff we face.

The fiscal cliff refers to the $600 Billion in tax increases and spending cuts that will automatically occur on January 1, 2013 if Congress fails to act before the end of the year (92 more days as of this writing on October 1, 2012).

Please allow me to refresh your memory as to how we now find ourselves at the edge of this economic precipice: In 2011 we had reached the legal, authorized limit, for borrowing money or our debt ceiling cap. The compromise approved by Congress allowed the debt ceiling to rise to $16.4 Trillion. In this compromise, Congress not only raised the debt ceiling but also required $1.2 trillion in savings for deficit reduction. The "Super Committee" in Congress and the Obama administration failed to support any deficit reduction proposal, including the Simpson/Bowles recommendations.

Last year, the political brinksmanship caused a downgrading of our United States credit by the S&P rating service. The US treasury predicts we will reach the cap limit in the first quarter of 2013.

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The Presidential Election's Effect on the Stock Market

By Christopher M. Lee, CFP®

Over the past several weeks, I have received several phone calls on what possible effect the election will have on the stock markets and which candidate would be best served for their portfolio.

For the broad markets, if election-year patterns are any guide, investors can expect solid gains for their 2012 stock portfolios. Indeed, the Standard & Poor's 500 Index has risen in the final seven months in 13 of the last 15 presidential elections, according to the Stock Trader's Almanac. And since 1896, the Dow Jones Industrial Average has produced an average 9% gain during election years when an incumbent president sought a second term – regardless of the outcome.

But the fortunes of individual sectors will also rise and fall in the years ahead depending on which political party wins the White House in November, since policy decisions impact corporate profits. *Please note that the following information is not a prediction, but educated guesses as to what might happen*.

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Fiscal Cliff Diving

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Please see my Newsletter dated April 2011 Volume 17 titled the "Moment of Truth" archived at www.newenglandcapital.com for more information on Simpson/Bowles.

It seems unlikely to me that Congress will resolve the deadlock before elections. This will leave the lame duck Congress responsibility to come up with a solution to the pending fiscal cliff. According to the non-partisan Congressional Budget Office some of the changes that will take place on January 1, 2013 are:

- The top tax on ordinary income will rise from 35% to 39.6%, with additional increases in Medicare taxes likely, as well.
- The top tax rate on dividends will go from 15% to 39.6% and from 15% to 20% on capital gains. Again, both would be affected by additional increases in Medicare taxes.
- The temporary 2% point cut in payroll taxes, effective in 2011 and 2012, will end.
- Automatic spending cuts that could ultimately amount to $1.2 trillion over 10 years will commence half from budgets for domestic programs and half from the military.
- The changes in the tax policies represent at least $399 billion in increased revenue, or lost income to individuals.

The good news is that the fiscal cliff will result in a deficit reduction of $607 billion for fiscal year 2013. The bad news is the higher taxes and spending cuts will likely cause the economy as measured by Gross Domestic Product (GDP) to contract by 3.6%. If the GDP growth rate is 1.6% now, this means the US economy would again be in a recession.

Obviously there is hope that Congress and the President will do the right things before the clock strikes midnight on New Years Eve. Even if they do, I still think the behavior of the elected leaders is shameful. Damage has already been done. Besides the down grade to our nation's credit rating, the fiscal uncertainty is certainly a contributing factor to the economic doldrums we are currently experiencing.

Recent studies offer evidence that policy uncertainty has dampened the recovery and suppressed job creation. Stanford economist Scott Baker and Nicholas Bloom and University of Chicago's Steven Davis estimate the rise in uncertainty from 2006 to 2011 resulted in 16% drop in private sector investment and a drop of employment of 2.3 million jobs. Their findings are consistent with earlier studies by Harvard University's Dani Rodrik, which showed uncertainty acts like a tax on investments. Also, in a just-released study by San Francisco Federal Reserve Economists Sylvan Luc and Zherg Liu, offer more hard evidence of uncertainty's depressing effects. When people don't know what government will do next, they are less willing to spend and invest. They found higher unemployment levels by 1%-2%. Or put another way, 1.5 million to 3 million more people would be currently employed.

Whether you are a CEO making a decision on building a new plant or a family deciding on whether to buy a new car, both are probably reaching the same conclusion: "Let's wait and see what happens before we spend any money." Even a college professor in the early 1980s knew this when Professor Benjamin Bernanke (now chairman of the Federal Reserve Bank) wrote a paper saying "Uncertainty, because it increases the value of waiting for new information, retards the current rate of investment."

I never told my son that there was one more level of uncertainty when I was cliff jumping and swimming at the Portland Quarry. The Portland Quarry is now family recreation destination with Lifeguards, requiring personal floatation devices and other safety measures. Back in my day, it was an abandoned brownstone quarry which we were probably trespassing. It is funny how time can change your perspective. I'm sure if we got caught, I would have argued with my parents (and of course lost the argument) that it was just youthful enthusiasm and a harmless transgression. As a parent now, I'd call it risky actions by kids who should have known better. Maybe we can tell our elected leaders that they are taking risky action and they should CERTAINLY know better.

The best thing to give to your enemy is forgiveness; to an opponent, tolerance; to a friend, your heart; to your child, a good example; to a father, deference; to your mother, conduct that will make her proud of you; to yourself, respect; to all men, charity."

-Benjamin Franklin, founding father of the United States of America

The Presidential Election's Effect on the Stock Market

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IF ROMNEY WINS

A win for Republican presidential candidate Mitt Romney, may likely bode well for dividend-paying stocks, mainly utilities, telecommunications and consumer staples (essential consumer products). That's because Romney would likely hold the dividend tax rate at 15% rather than allowing the Bush-era tax cuts to expire, making those stocks more attractive.

Under President Barack Obama, the wealthiest taxpayers could pay 39.6% on dividends (assuming the Bush tax cuts expire) plus a new 3.8% tax on passive income from dividends, interest and capital gains, compliments of the 2010 health care law. For those people making $200,000 or more (and households making $250,000 or more), the dividend tax for them would effectively triple.

Also, the energy sector, may also favor a Romney win. The GOP candidate has said he would authorize a dramatic increase in the domestic production of oil and natural gas to enable North American energy independence by 2020. His plan would remove federal roadblocks to fracking, authorize drilling on federal land and off the East Coast, and green light the Keystone XL pipeline to transport crude oil from Canada to refineries throughout the U.S. Obama has delayed any decision on the pipeline until 2013.

In addition to dividend payers and energy companies, the banking sector may also benefit from a Republican administration, as many believe the party would ease restrictions imposed upon the financial services industry by the Dodd-Frank Act, a federal law that places regulatory oversight into the hands of the government.

IF OBAMA WINS

Unsurprisingly, an entirely different basket of stocks would cheer if Obama were re-elected. Homebuilders are among them, as the current administration continues to enact programs to bail out delinquent homeowners and speed the resolution of the foreclosure mess. This may result with a leaner inventory of homes on the market and therefore create the demand for new homes.

Pharmaceutical stocks may also benefit from another Obama term. While the $85 billion in fees imposed upon drug companies over the next decade to help pay for Obamacare will negatively impact earnings, the individual mandate requiring all Americans to have government-approved health insurance will more than offset any losses for those companies. Even though the pharmaceutical companies will take an earnings hit as a result of the fines, the mandate provides a very needed inflow of patients who were previously uninsured. When patients have insurance, they tend to utilize it, so consumption of healthcare services and products tend to accelerate.

OVERALL ANALYSIS

For the short term, if history repeats itself, investors may also have gains in the market following the election. In election years, the S&P 500 tends to make its annual high in November and December after the election.

While I did outline a couple of "possible winners and losers" for each party, I want you to keep things in perspective for the long term. Whichever candidate wins, it will not be the end of the world or capital markets for that matter. What I have learned in my 20 years in this business is that history does tend to repeat itself. Conventional wisdom, for example, has long maintained that Republican administrations, wielding tax credits and business friendly regulations, are better for the markets. BUT – that is always not the case. A couple of years ago, I wrote an article entitled "Which Party is Better for the Markets" (Volume 15) and included this chart below:

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"No man can become rich without himself enriching others."

-Andrew Carnegie: 19th century captain of American industry

"We are what we repeatedly do. Excellence, therefore, is not an act, but a habit."

-Aristotle, Greek Philosopher

	1900 - 2005		1950 - 2005		1975 - 2005	
(Party's Ranked in order of return)	**Annual Return**	**No. of Yrs. Occurred**	**Annual Return**	**No. of Yrs. Occurred**	**Annual Return**	**No. of Yrs. Occurred**
Republican Congress, Democratic President	7.1%	10 yrs	17.0%	6 yrs	17.0%	6 yrs
Republican Congress	6.4%	38	14.7%	11	13.5%	9
Republican President and Congress	6.2%	28	11.9%	5	6.4%	4
Republican President	4.3%	58	4.0%	33	6.5%	19
Democratic President	3.8%	48	5.7%	23	5.8%	12
Democratic President and Congress	2.9%	38	1.7%	17	-5.4%	6
Democratic Congress	2.7%	58	2.0%	37	3.4%	14
Divided Congress	2.7%	10	3.0%	8	3.0%	8
Republican President, Divided Congress	2.7%	10	3.0%	8	3.0%	8
Democratic Congress, Republican President	2.3%	20	2.3%	20	10.0%	8
Democratic President and Divided Congress	-	0	-	0	-	0

Source: Ned Davis Research, Inc.

After reviewing the chart above, you can make the following observations from the above 105 years of history:

- Best combination for stocks: Republican Congress with a Democratic President
- Most positive factor for stocks: A Republican Congress
- Worst combination for stocks: Democratic Congress with a Republican President
- Best record against inflation: Republican Congress
- **Least significant factor for stocks: Party of the President**

With that being said, sit back and enjoy the next several entertaining weeks leading up to November 6th. I hope you all go out, exercise your American liberties, and VOTE for the best candidate for the job!

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