Aug 28th , 2012
Volume 11, Issue 2

Intelligent Money

Current thinking from Haven Financial Advisors

Louis Kokernak CFP, CFA
Haven Financial Advisors
Austin ~ Dallas
voice 512 791 4335
toll-free 800 898 5480
fax 800 888 5480
louis@havenfinancial.com

Special Notes of Interest:

Political futures contracts trading in the United Kingdom indicate that President Obama enjoys a 57% chance of being re-elected President of the United States. See www.intrade.com for real time updates.

Total health expenditures in the USA reached $2.6 trillion in 2010, which translates to $8,402 per person or 17.9 percent of the nation's Gross Domestic Product

Since 1990, Medicare spending has increased at an annual rate of 8.1%. The CPI increased at a 2.6% rate over the same period.

The Fiscal Cliff and the Individual Investor

At the end of this calendar year, substantial changes in Federal taxation and spending are scheduled to become law. These changes promise several hundred billion dollars in reduced federal spending and increased taxation. In short, they are austerity measures often referred to as the "fiscal cliff". Investors should be aware of the implications of the new tax regime that may prevail in 2013.

How Did We Get Here?

The biggest piece of the fiscal cliff started back in 2001 and 2003 with the passage of tax reform acts now known popularly as the Bush tax cuts. Both pieces of tax legislation reduced personal income and capital gains tax rates. Estate taxes and the alternative minimum tax were also limited. These measures incorporated sunset provisions as a device to facilitate their passage. They were scheduled to expire at the end of calendar 2010. Given the stagnant economy that prevailed that year, Congress and the President agreed to extend the tax cuts to the end of 2012.

Here we are two years later facing a predicament similar to what the lame duck congress faced in December 2010. The stakes are higher, though as more taxes and spending changes have been layered in. The same legislation that extended the Bush tax cuts also included a reduction in the social security tax. This tax is scheduled to revert to its higher level in the new year. The passage of the Obamacare law included the phase in of some new taxes. On January 1st, 2013, higher income individuals will be subject to a new tax on unearned income and a new payroll tax.

Those are the main tax changes contemplated at year's end. There are also some mandated spending cuts. Last year's standoff on the Federal debt ceiling culminated with the Budget Control Act of 2011. The Act raised the debt ceiling but created a congressional super committee to designate $1.2 trillion in budget cuts over the next ten years. If it failed to do by Thanksgiving 2011, across the board cuts to a wide swathe of federal programs would be mandated … starting in 2013. To no one's surprise, the supercommittee failed its mandate triggering budget reductions start after the new year. About $110 billion in cuts are scheduled for 2013.

There are miscellaneous items as well. The extension of unemployment benefits lapses at year end. Medicare payments to doctors will be cut substantially. The Child Care tax credit gets reduced. Some research and investment tax credits for business likewise expire.

Economic Impact

The Congressional Budget Office (CBO) has attempted to quantify the impact of the bundle of tax and spending changes scheduled to occur at year's end. According to CBO's estimates, the "fiscal cliff" policies will reduce the federal budget deficit by 5.1 percent of GDP between calendar years 2012 and 2013. That's over $750 billion in one year – real money!

Since these measures will likely reduce economic activity, the actual reduction of the deficit will be smaller. In fact, the CBO just announced Wednesday that a recession is a *probability* in 2013 if the scheduled austerity rules proceed apace. CBO projects that unemployment increases to 9% and GDP falls by 0.5% by year end 2013 under that scenario.

Tax Impact on the Average Family

A family of three with an income of $50,000 will see its income tax bill increase to $6400 in 2013. That's an increase of $1550. They will also pay an additional $1000 in social security taxes. The key drivers of the increased taxes are the reinstatement of higher personal income tax rates that prevailed prior to 2001. As an example, the top personal tax rate will increase from 35% to 39.6%. Capital gains tax rates will increase for most investors from 15% to 20%. Dividends will be taxed at the individual's top marginal rate, up from 15% for most filers.

There are other measures not directly related to the Bush tax cuts. Social Security taxes will be restored to 6.2% from 4.2%. This will disproportionately affect poorer salaried workers. The new Obamacare taxes will affect higher income earners. There will be a 3.8% surtax on capital gains and dividends and a 0.9% increase in the payroll tax. Something for everyone.

Investors that tilt their portfolios towards high yielding stocks may want to revisit this strategy. After January 1st, dividends will be taxed at ordinary income rates rather than the favorable rate of 15%.

The Road Ahead

Opportunity for congressional action is rather thin between now and year's end. The adversarial political climate leading up to the election makes congressional action difficult prior to November. Congress has a "lame duck" session that runs from November 13 through December 14. Will an exiting congress be interested in making tough decisions in a tight timeline?

There is some speculation of a "deliberate cliff dive". That is, action would be deferred until the 113th Congress sits on January 3rd . That new congress could restore some of the 2012 tax regime and call the legislation "tax cuts". Whatever tax increases or spending cuts remain could be labeled "deficit reduction". It might be a more politically attractive framing of the issue.

The Investor's Response

No one can predict the course that Washington will take to reduce the size of fiscal cliff. It does seem, however, that at least some scheduled tax hikes will occur. That does argue for investors to accelerate income into 2012. The reason is simple. Tax rates are likely to go up after year's end. It's better to take some income now rather than pay a higher rate later. There are some fairly simple ways to control the amount of income that is brought into the current year.

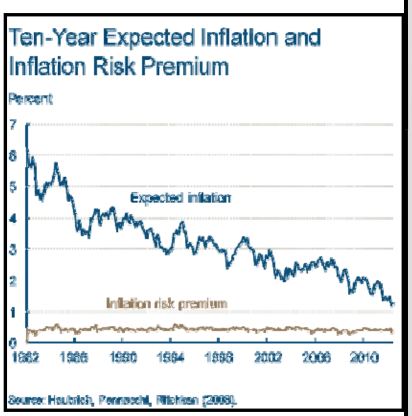
Many investors have unrealized capital gains in their portfolios. Some of these gains may be good candidates for capture in 2012. For most, the relevant tax rate is 15%. Depending on income levels, that tax rate is slated in 2013 to increase to 20% or 23.8%. That's a big change.

Higher ordinary income tax rates in 2013 argue for Roth IRA conversions this year. Here, the investor transfers funds from a traditional IRA to a Roth – paying taxes on the income recognized in the transfer. In effect, we pay taxes now in exchange for tax free growth in the future. This is a good idea if it looks like tax rates are going up.

Investors that tilt their portfolios towards high yielding stocks may want to revisit this strategy. Dividends will be taxed at ordinary income rates rather than the favorable rate of 15%. Many will see the tax rate on dividends double after the new year.

More generally, passive or tax efficient investing will become more important in the coming years. With taxes on capital gains and dividends increasing, investors should minimize portfolio turnover and reduce dividends in taxable accounts. Investors in indexed funds rarely see appreciated stocks sold within the fund. That's the salutary tax effect of indexing. There are also tax managed funds - that deliberately avoid the sale of appreciated stocks to produce even greater tax efficiencies. Structuring portfolios to minimize taxes is often a good idea. It may be an even better idea after January 1st. Passive investors already have a head start.

Inflation Expectations



Some years ago, an issue of *Intelligent Money* discussed market based measures of anticipated inflation. We compared the nominal treasury yield curve with yields of treasury inflation-protected securities (TIPs) to infer an inflation forecast. In recent times, over the counter inflation rate swaps have provided additional market based insight into inflation rates and their risk premiums.

The Cleveland Federal Reserve branch has developed a comprehensive inflation forecast model that relies on TIPs, swaps, and professional surveys. The forecast calls for remarkably little inflation. Despite an accelerated growth in government debt and money supply over the past few years, the federal treasury continues to borrow at near record low yields. The status of the US dollar as a reserve currency and the well publicized problems of its chief monetary rival, the Euro, have thus far kept demand for US debt strong.

Apparently, this investor confidence in the US currency is bolstered by both market based and survey data related to inflation. The latest forecast from the Cleveland Fed is a low annual rate of 1.26% over the next ten years. That is about as low as it has ever been (see chart at left). Moreover, real interest rates offered by US government bonds have fallen decisively into negative territory in 2012. For most individuals, excessive borrowing drives up borrowing costs. Not for Uncle Sam – not yet anyway.