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FISCAL CLIFF PRIMER

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As we move closer to the US presidential election and the end of 2012, we are hearing more about the devastation that the so-called "fiscal cliff" will have on the US economy. I want to really look at what is at stake here.

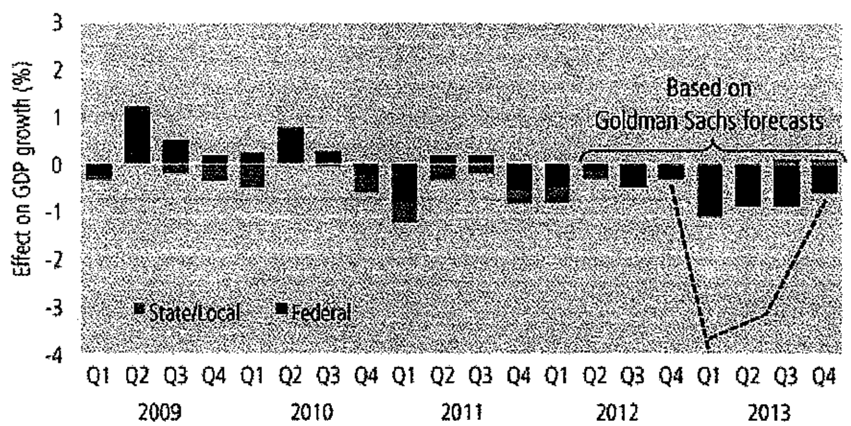
The **fiscal cliff** refers to $600 billion in tax increases and spending cuts that will occur on 1 January 2013 should Congress not extend what have become known as the Bush administration tax cuts that were put in place in 2001 and 2003 and the payroll tax cut in place for the past two years. The spending cuts come from the sequester, which I will explain, and the expiration of unemployment benefits.

The **sequester** pertains to the $109 billion per year in cuts set to take effect at the beginning of 2013 because the deficit reduction "super committee" failed to achieve $1.2 trillion in savings. Those savings were agreed to when Congress raised the debt ceiling last year.

The **debt ceiling** is the legal cap on the amount of debt the US Department of the Treasury can issue. It currently stands at $16.4 trillion. The United States is likely to hit this debt ceiling in the first quarter of 2013. If Congress does not act to raise the debt ceiling, the federal government will no longer be able to borrow to fund its deficit, forcing a drastic reduction in expenditures that could affect everything from Social Security payments to federal grants.

All of this would amount to a huge logjam for the US economy. Right now the economy is growing at a rate of 1.6%. If all the tax increases and spending cuts take effect, we will likely see the gross domestic product (GDP) contract by about 3.6%, which would mean the US economy would be in recession.

Fiscal cliff may sap momentum from US recovery



Source: GS Global ECS Research. As of 15/5/12.

BUILDING BETTER INSIGHTS℠

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Possible outcomes

Obama wins and Democrats take control of Congress

Given the political divisions between congressional Republicans and Democrats, I do not expect to see a deal on any of the fiscal issues before the elections on November 6. Americans will elect a president, one-third of the Senate and the entire House of Representatives. Given the possible changes, investors should keep an eye on this election. If Barack Obama is reelected and Democrats gain the majority in Congress, then it is likely that taxes will be increased. However, I expect that taxes on dividends and capital gains (both now at 15%) may be raised but not to the levels they were before the Bush tax cuts. It is also likely that the payroll tax will be reinstated and that the sequester will not occur.

Republicans take control

If the Republicans win control of the White House and Congress, then the tax cuts now in place will be continued for several years and the sequester will not take place as planned. The cuts may, however, be stretched out over time. In that case, the economy would probably suffer, but recession would likely be averted.

If Washington does not agree on a solution, the economy, which is now growing slowly and in the middle of its business cycle, could tip into recession. We would then see the full effect of the tax and spending cuts take hold. The resultant slowdown in the United States could have negative effects on economies in emerging markets and Europe and could in effect create another global economic crisis.

What is likely to happen?

I do not think it is in anyone's interest to trigger economic failure. I believe that politicians in Washington are aware of the fragile economic environment. They will likely put together enough emergency legislation to delay, postpone and defer the crisis, leaving another Congress to deal with the issue. They will not, however, allow a lethal combination of tax increases and government cutbacks to occur all at once. It appears that there is room for a compromise — to increase taxes on top earners while raising taxes, but not as drastically, on the middle class.

Furthermore, the taxes for health care and unemployment benefits could be modified and staggered to allow the economy and the business cycle to heal. In that event, the business cycle would continue, and neither corporate profits nor equity valuations would be impaired.

And then this crisis will be forgotten as was the debt ceiling crisis of last summer.

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IF YOUR BUDGET RESEMBLED THE U.S. GOVERNMENT'S

Figures adjusted to various income levels

The United States is outspending revenues, creating a rising deficit and higher debt levels. The numbers are so large that it is difficult to comprehend their size.

The chart below scales the federal numbers down to a more manageable size. It shows what would happen if U.S. households were to run their finances the same way the government runs its own. Here is what their balance sheet would look like.

Federal budget challenge

	U.S. government	Real median household	Hypothetical household A	Hypothetical household B	Hypothetical household C
Tax revenue/Income	$2,302,000,000,000.00[1]	$49,445.00[3]	$100,000.00	$250,000.00	$500,000.00
Current spending	$3,598,000,000,000.00[1]	$77,281.98	$156,298.87	$390,747.18	$781,494.35
Annual deficit	$1,296,000,000,000.00[1]	$27,836.98	$56,298.87	$140,747.18	$281,494.35
Accumulated debt	$15,222,940,045,451.09[2]	$326,975.79	$661,291.92	$1,653,229.81	$3,306,459.61

Methodology

Due to the sheer size of the numbers, the U.S. federal budget was scaled down by dividing the U.S. median household income level for 2010 (the most recent figure available) by the actual 2011 federal tax revenue, computing a rate of 0.000002148%. This factor was then applied to the actual current federal spending, deficit, and accumulated debt for 2011. The same concept was applied to the three alternative hypothetical household income levels.

[1] United States government numbers taken from the Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2012 to 2022* Summary Table 1, page xii.

[2] Accumulated debt taken from TreasuryDirect.gov for December 31, 2011.

[3] United States median household income level taken from U.S. Census Bureau, *Income, Poverty, and Health Insurance Coverage in the United States: 2010.*

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WORRIED ABOUT INFLATION? YOU PROBABLY SHOULD BE.

Many investors cite inflation as one of their primary worries. Over time, inflation will erode your purchasing power if the return you earn on your money is less than the inflation rate. There are two inflation rates, reported as the Consumer Price Index (CPI) by the Bureau of Labor Statistics. "Headline" inflation represents the change in price for a broad bundle of products and services. "Core" inflation excludes food and energy. While the core inflation rate is generally lower, headline inflation is more realistic because it reflects all the living expenses consumers have.

So for every dollar invested in a 6-month CD, you lost 2.647%. A deposit of $1,000 would be worth only $973. It's hard to meet long-term goals with short-term investments. The chart below shows what would have happened to your spending power if you had stayed invested in 6-month CDs for the past 10 years.

Current rates of inflation[4]	
Core inflation	2.2%
Headline inflation	3.0%

Here is an example of real, after-tax return on six-month CDs for 2011.

Taxes and inflation determine the real rate of return	
Current rate for a 6-month CD	**0.420%**
Minus portion of return used to pay taxes (at a 25% tax rate)	−0.105%
Equals after-tax return rate	**0.315%**
Minus current headline inflation rate	−2.962%
Real rate of return	**−2.647%**

As of 12/31/11.

Year	6-month CD[1]	Federal tax rate[2]	After tax return[3]	Inflation[4]	Real rate of return[5]	Value of $1000
2002	1.81%	27%	1.32%	2.38%	-1.06%	$989
2003	1.17%	25%	0.88%	1.88%	-1.00%	$980
2004	1.74%	25%	1.31%	3.26%	-1.95%	$960
2005	3.73%	25%	2.80%	3.42%	-0.62%	$954
2006	5.24%	25%	3.93%	2.54%	1.39%	$968
2007	5.23%	25%	3.92%	4.08%	-0.16%	$966
2008	3.14%	25%	2.36%	0.09%	2.26%	$988
2009	0.87%	25%	0.65%	2.72%	-2.07%	$968
2010	0.44%	25%	0.33%	1.50%	-1.17%	$956
2011	0.42%	25%	0.32%	2.96%	-2.65%	$931
Average	2.36%	25.20%	1.77%	2.48%	-0.71%	N/A

Regardless of the investment, it is important to consider the inflation rate when determining what you are really earning on your money. For a more detailed understanding of how inflation impacts your portfolio, talk to your financial advisor.

Keep in mind that CDs may be purchased for longer periods than illustrated. The six-month CD rate was used as an example to illustrate the effects of taking money out of the market because of volatility. Had longer-term CDs been used (such as a 60-month CD), the results would have been different. CDs are insured and offer a fixed rate of return, whereas the principal and yield of investment securities will fluctuate with changes in market conditions.

1 Source: Federal Reserve Annual Statistical Release for 6-month CDs (federalreserve.gov). **2** Source: The Tax Policy Center. Highest marginal federal tax rate is based on $100,000 of taxable income for a married couple filing jointly (taxpolicycenter.org). **3** The after-tax return is calculated by taking the rate of return and multiplying it by what's left after taxes (100 minus the tax rate). **4** Inflation is represented by the Consumer Price Index (CPI). The table shows "headline" inflation. **5** Real return is calculated by taking the after-tax return and subtracting the inflation rate.

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WHAT KEEPS YOU UP AT NIGHT?

Please take a minute to review the topics and related questions below. Check off any concerns you have right now. Chances are I have information that will help us address many of the issues that may worry you.

RETIREMENT

- [ ] Will my money last through retirement?
- [ ] Do I need long-term care insurance?
- [ ] What are my retirement investment options?
- [ ] How do I manage all my retirement plans?
- [ ] What should I do with my employer retirement plan?
- [ ] Since I'm retiring soon, what do I need to do now?
- [ ] Should I retire to a different state?

EDUCATION PLANNING

- [ ] How much should I save? When should I start planning?
- [ ] Will I qualify for financial aid? Where do I start?
- [ ] What are my college savings options?
- [ ] How do I teach my children about money?

LIFE EVENTS

- [ ] What happens to my 401(k) when I change jobs?
- [ ] What are my options if I'm laid off?
- [ ] I'm getting divorced. What happens to my assets?
- [ ] What do I do when a loved one dies?

ELDERCARE

- [ ] How does Medicare work?
- [ ] What should I look for in a nursing home?
- [ ] How do I cope with Alzheimer's disease?
- [ ] What happens if I have to care for my parents?

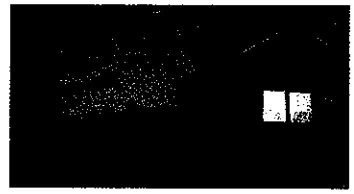
ESTATE PLANNING

- [ ] What should I know about estate planning?
- [ ] How do I protect my estate from taxes?
- [ ] Will my family be secure if something happens to me?
- [ ] How do I create a legacy for my children?
- [ ] Can I provide for my favorite charity when I'm gone?
- [ ] What will my survivors need to know?

FINANCIAL BASICS

- [ ] How do I keep my records safe and organized?
- [ ] How do I do a better job budgeting? How do I reduce my debt?

REQUEST INFORMATION



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BEST TIME TO CALL

This material should be used as helpful hints only. Each person's situation is different. You should consult your investment professional or other relevant professional before making any decisions.

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