

Orlando's Outlook: Obama's fiscal policy compromise—the stimulus we should have done last year

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November's shockingly weak employment report released last Friday morning sent members of Congress and the Obama Administration scurrying for a solution over the weekend, resulting in a bold fiscal policy compromise by President Obama to jumpstart job creation and stimulate stronger economic growth.

The president's \$900-billion, bipartisan proposal was met with universal approval on Wall Street, as economists from across the political spectrum believe that this fiscal policy compromise, as presently constructed, could add 0.5% to 1% of additional growth to Gross Domestic Product (GDP) in 2011, which would take next year's estimated GDP up to a range of perhaps 3% to 4%, based upon current consensus estimates. We had been estimating 2.8% GDP growth in 2011 before the president's announcement Monday night, and will revisit our forecast later next week.



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Economists believe that the faster economic growth could reduce the unemployment rate next year by perhaps 0.5 to 1 percentage point below current forecasts, and possibly 1½ points lower by the end of 2012. At present, we expected unemployment, which is a lagging economic indicator, to continue rising to 10% in coming months before peaking and beginning to recede to perhaps 9% by the end of calendar 2011 and to 8% by year-end 2012. So that rate of unemployment could fall more quickly to 8% or 8.5% by the end of next year and perhaps to 6.5% or 7% by the end of 2012.

In addition, the stronger economic growth arising from this stimulative fiscal compromise and the accompanying potential increase in employment of taxpaying Americans could generate some \$100 billion to \$200 billion of additional federal tax revenue next year, over and above current tax-revenue forecasts for 2011, as taxpayers actually will pay more absolute tax dollars at lower rates in a more vibrant economy. And with less people out of work, government transfer payments for unemployment insurance will drop, too, as we begin to close a gaping federal budget deficit.

There are eight key elements to the president's win-win, bipartisan fiscal policy compromise:

1. **Extend the soon-to-expire Bush tax cuts across the board for all income groups for two years.**

This is the centerpiece of the proposal and provides the biggest bang for the buck. At present, the Bush tax cuts are set to expire at the end of this calendar year, which—if left unchanged—will result in a sharp tax increase across the board for working Americans. Given the fragility of the current economic recovery, such an occurrence would materially increase the chances of a double-dip recession, according to Larry Summers, the current chairman of President Obama's National Economic Council.

This Republican-inspired initiative is also the most controversial element of the president's proposal, as some Democratic critics contend that the wealthiest Americans don't need the tax break. The economic reality, however, is that many of these upper-income taxpayers with annual family income of \$250,000 or more are small business owners who are driving hiring decisions, and they are also responsible for the bulk of the robust recovery in consumer spending retailers have enjoyed over the past year and a half. If we want more hiring and more consumer spending, lower taxes for the upper echelon are a critical element to achieve those objectives.

2. **Extend unemployment benefits for 13 months.**

There are 7 million Americans who are long-term unemployed and whose benefits are about to expire after 99 weeks. During the Christmas season, this Democratic-inspired proposal compassionately extends their unemployment benefits through the end of calendar 2011. But many economists also point out that extending long-term unemployment benefits may actually be keeping the rate of unemployment artificially high for a longer-than-normal period of time, as the existence of these benefits creates a higher "hurdle rate" in the minds of some job seekers, preventing them from taking a growing number of available job opportunities.

3. **Payroll tax holiday in 2011.**

President Obama proposes to cut the Social Security tax rate from 6.2% to 4.2% for all employees, but leave the

employer's share unchanged at 6.2%. Social Security taxes currently apply to the first \$106,800 in wages each year, which translates into a maximum tax benefit of about \$2,100 over the course of next year. This is a major improvement in economic stimulus over the president's February 2009 fiscal policy plan, which offered maximum tax benefits of \$400 for each individual and \$800 for couples, spread over a two-year period.

But some economists believe that extending that payroll-tax cut to employers, too, would actually help to stimulate faster job creation. We believe that one of the best elements of President Obama's St. Patrick's Day 2010 jobs bill was to exempt employers from paying their 6.2% Social Security payroll tax for 2010 for hiring new employees who had previously been unemployed for at least 60 days.

4. Estate tax is re-established at 35% for two years with a \$5 million exemption.

Last year, the estate tax rate was set at 45% with a \$3.5 million exemption, and next year the tax is scheduled to be 55% with a \$1 million exemption. But through a quirk in the tax law, the estate tax is currently lapsed, and Yankee fans cheer the fact that George Steinbrenner picked the right year to die. This Republican-inspired initiative is also quite controversial. Republicans would prefer the so-called "death tax" eliminated, believing that it is unfair to tax assets again that have previously been taxed during the deceased's lifetime. Democrats are viscerally opposed to this plank, as they see an opportunity to raise more revenue from the "wealthy" by re-establishing 2009 estate-tax levels.

5. Allow companies to write off 100% of their capital purchases next year.

Republicans championed this proposal for accelerated depreciation, which potentially provides a boon for robust capex business spending next year by permitting companies to expense their big-ticket equipment purchases immediately, rather than slowly depreciate them over several years.

6. Keep temporary tax breaks for working families and students for two years.

This is a key proposal for the Democrats, focusing on the Earned Income Tax Credit, which helps families with three or more children; the Child Tax Credit, up to \$1,000 per child based on income; and the American Opportunity Credit, with a maximum credit of \$2,500 for undergraduate education expenses.

7. Patch the AMT for two years.

Democrats insisted on this two-year patch for the Alternative Minimum Tax (AMT), which covers 2010 and 2011 and without which an estimated 21 million middle-class taxpayers would have been subjected to a reduction in their deductions and higher taxes. Higher wage earners are already paying the AMT and will continue to pay higher taxes.

8. Capital gains and dividend tax rates will be extended at 15% for two years.

This Republican idea will benefit both institutional investors and those individuals who are saving for their retirement and for their children's college education. The discussion in Washington up until recently had been to raise the tax on capital gains from 15% to 20% and add on a 3.8% Medicare unearned-income surcharge, for a new rate of 23.8%, which would have represented a nearly 59% increase in the capital-gains tax. The tax on dividends was to increase from 15% to the new maximum marginal tax rate of 40% plus the 3.8% Medicare unearned-income surcharge, for a new rate of 43.8%, which would have represented a near tripling of that tax on dividends.

Our legitimate fear is that if the Bush tax cuts were not extended and the capital gains and dividend taxes were not kept at their prior levels, then we could see a sizable wave of year-end 2010 tax selling in the equity market. Hopefully, that potential crisis has been averted.

Bottom Line

In the aftermath of the wave election results on November 2, we believe that President Obama exercised strong political leadership during this lame-duck session of Congress to craft a Solomon-like, fiscal-policy compromise to address several impending land mines and jumpstart job creation and stimulate stronger economic growth. It appears that the bond market has already gotten the memo, as benchmark 10-year Treasury yields have soared from less than 2.40% in early October to more than 3.30% this week, as the bond vigilantes are starting to price in stronger economic growth and higher levels of inflation next year.

For its part, the S&P 500, after its post-election correction of about 5%, has rallied back to a new 52-week high of about 1,237 today on the heels of the president's proposal, which is close to our long-standing, full-year target price of 1,250. We

think stocks will continue to grind higher through year end, and we expect more of the same in calendar 2011, with our mid-year target of 1,350.

But equity investors remain somewhat reticent at present, we believe, in the wake of vocal dissension among Democrats about President Obama's proposal, which needs to be approved by the lame-duck Congress before they leave for good next week. So the ideological intransigence personified by outgoing House Speaker Nancy Pelosi is a market risk, of course, although we fully expect that the new Republican-controlled House will correctly approve this measure when they take control next month, if the current lame-duck crew fails to do the right thing for the American people and the U.S. economy.

Views are as of December 10, 2010, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

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