

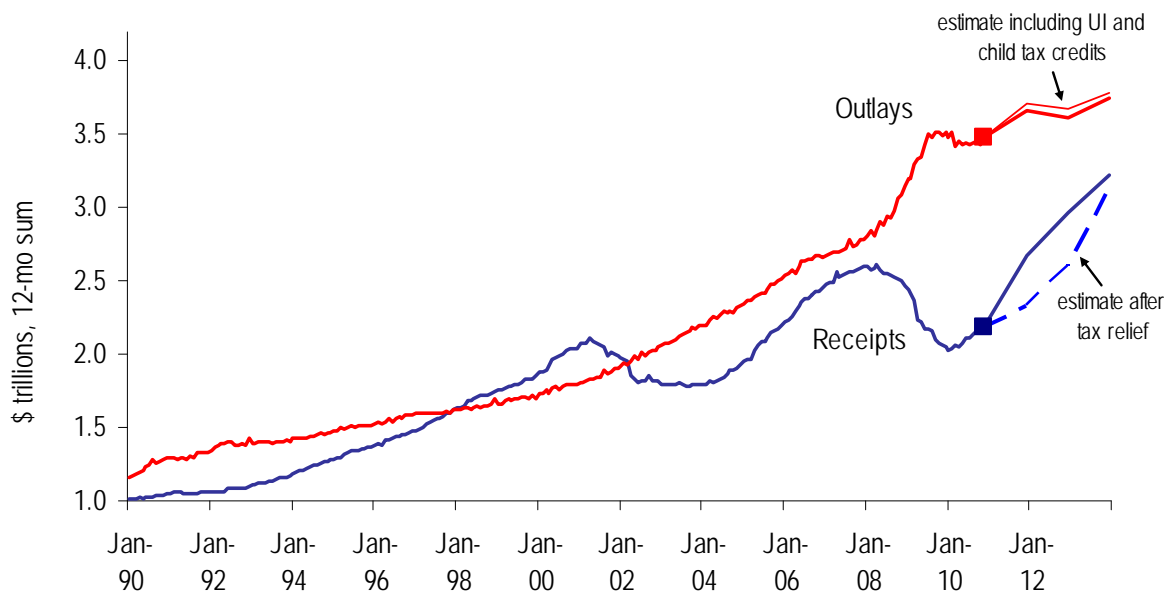
December 17, 2010

Impact of Washington's Tax and Spend Finale

As Congress rushes to adjourn, the tax bill is done and, we think, already priced into financial markets and the economic outlook.

- Most of the bill consisted of extending current tax rates and subsidies and was assumed in the consensus outlook. While scored as a \$917 billion increase in the deficit in the first three years (as shown in the graph and the attached scoring estimate), that is measured against a baseline which assumed an increase in tax rates. From an economic standpoint relative to 2010, the only changes due to the bill are the cut in the social security tax rate and the end of the Build America bond subsidy used for taxable state and local borrowing in 2009 and 2010 (their issuance will now go back to tax-exempt bonds.)

Federal Receipts and Outlays (last obs. November 2010, estimated to 2013)



Source: CBO; Encima Global

- The cut in the employee's portion of the social security tax substitutes for the Making Work Pay credit available in 2009 and 2010. It is like a series of tax rebate checks, which we think have limited impact on consumption because they are temporary and tend to be offset by concerns about the deficit. It's scored as a \$112 billion cost in FY11 and FY12. The May 2008 Bush rebates were scored at roughly \$110 billion for the

means-tested \$1200 checks to joint filers (\$600 max to individual filers) and had only a small impact on second quarter 2008 GDP growth. For someone making \$60,000, the new 2% social security tax rate cut would be \$1200 spread over one year, or \$100 per month. Our view is that it may boost consumption a bit on the margin.

- The extension of unemployment insurance doesn't improve the economic outlook, in our view, because the added cash flow is offset by reduced labor mobility and increased national debt.
- The temporary equipment-expensing provisions don't have much impact because: 1) they are not that big; 2) they are temporary, causing a shift in the timing of purchases but not the total amount; 3) much of the equipment will be produced abroad; 4) many businesses don't use very much equipment and will be disadvantaged by the targeted subsidy to equipment users.

We expect 3% real GDP growth in the fourth quarter; and 3-4% in 2011 due to the gradual improvement in the labor environment, pent-up demand and foreign growth. In our October and November tax pieces, we thought deficit considerations would complicate the year-end tax debate more than it did. We had factored in a 50-50 chance that there wouldn't be a tax deal, which would have caused a substantial first-half 2011 slowdown. The consensus view had higher odds of a tax deal, so we don't expect much further improvement in the consensus outlook due to final passage of the tax bill.

Year-End Spending Bill

The continuing resolution to keep the government running into 2011 is still hotly contested. Most important to markets is how long the bill extends spending into 2011 and whether it cuts spending from FY2010 levels. **If the bill includes spending cuts and/or is very short-term (e.g. lasting into February rather than all the way through September), it would be a material market surprise and quite favorable for the dollar and Treasury bonds because it would indicate a mechanism for fiscal restraint.** Spending restraint would be a long-term positive for U.S. equities on an absolute basis and relative to foreign equities, but it would probably bring short-term volatility for equities because some would emphasize the fiscal contraction and reduction in Keynesian stimulus.

- The normal appropriations process is for some of the twelve appropriations bills (for defense, the legislative branch, the Treasury Department, etc) to be passed individually and the remaining ones packaged into a long omnibus bill. These bills can increase or decrease spending for various programs (though not entitlements or tax subsidies) and are the result of hearings and negotiations within the House and Senate Appropriations committees. They often include earmarks. When there is an impasse in Congressional negotiations on the individual bills, continuing resolutions are used to maintain spending at previous levels until the normal appropriations bills are completed.
- This year, however, none of the 12 appropriations bills passed by itself and the Republicans have opposed a omnibus package of appropriations bills (too thick, too complicated, too expensive.) Over the next couple of days, Congress will probably

decide to use a continuing resolution extending into 2011. Important to markets is the length of the CR and whether it cuts (or increases) any spending levels.

- The length of the continuing resolution is important because it provides a point in time when Congress might negotiate spending cuts or process changes that will change the path of federal spending. The debt limit increase around May 2011 will be another deadline in which decisions might be made on spending restraint.

Net Impact of the Year-End Blowout

On the margin, the tax deal had more spending and transfer payments than expected, but the appropriations process may be headed in a better direction than expected. The Treasury bond market sold off on the tax deal but is rebounding some on the appropriations developments.

Importantly, we don't think the willingness of the President and senior Republicans to reach a tax deal clarifies the U.S. stance on structural reforms. Those are critical in the long-term U.S. growth rate and, in our view, in pricing U.S. equities relative to foreign equities. So far, this is a one-time year-end battle, and working relations between the President and the new Congress will have to be built from scratch in 2011.

- The President's State of the Union message at the end of January and his budget in February will give a sense of the President's stance on structural reforms. After that, the negotiations on a continuing resolution (possibly in February) and on the debt limit increase (around May) will show the new direction.

Apart from the possibility of spending restraint, we assume little in the way of structural reform in 2011 – no constructive individual tax reform, only minor corporate tax reform and minimal restraint on regulatory burdens.

- Even though the tax bill is just being completed, a key variable in the longer-term outlook is the 2012 extension of the Bush tax rates (maybe they'll be called the Obama tax rates.) The same debate will probably take place in 2012 and may drag into a lame-duck in December 2012, with uncertainty weighing on the economy.

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