MARKET INSIGHTS

The fiscal choice: Cliff, ledge or ladder

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Foreword

For American investors, the current economic environment seems more disappointing than dangerous. While the European recession and debt crisis continues, the European Central Bank should be able to avoid an absolute financial panic. Although the Chinese economy has slowed, both monetary and fiscal policies are being employed to recharge growth going into 2013. In the United States, while neither the Federal Reserve nor the federal government is in a position to help the economy, it does appear to still be on a slow expansion track. Additionally, second quarter earnings for the S&P 500 companies were the highest on record, while inflation remains very much under control. Given all of this, along with a wide valuation gap favoring stocks over fixed income, it seems strange that investors continue to pile money into bond funds and cash accounts while still shunning stocks.[1]

One reason for this behavior may be fear of the “fiscal cliff.” Without new legislation, at the end of 2012, the Bush tax cuts, the temporary payroll tax cut and extended unemployment benefits will all expire just as higher Medicare taxes and both rounds of cuts to discretionary spending agreed to last August take effect. According to the Congressional Budget Office (CBO), this would cut the budget deficit from 7.3% of GDP in fiscal year 2012 (which ends in a month) to 4.0% in fiscal 2013.[2] Even this understates the extent of the fiscal cliff, since fiscal 2013 includes three months before these changes are scheduled to take effect. On a calendar year basis, the projected drop in the deficit is closer to 4% of GDP.

Legislation to avoid the full impact of these changes is likely after the election. While Republicans and Democrats will disagree about how the deficit should be reduced, who should see higher taxes and what areas should be cut, in theory, there should be less debate about the appropriate *pace* of deficit reduction. However, one of the greatest dangers in the current environment is that a compromise is reached that still imposes huge fiscal drag on the economy in 2013 – a fiscal ledge rather than a fiscal cliff. Of course, what America needs is not a fiscal cliff or a fiscal ledge but rather a fiscal ladder – a plan to reduce the deficit steadily but slowly.

In the pages ahead, we examine potential scenarios for the budget going forward and what these scenarios imply for the economy and investing. Big changes are coming from Washington, and while investors can hope that common sense prevails and leads to a balanced, steady reduction in the deficit, they should be prepared to deal with the consequences of a variety of fiscal outcomes.

[1] On August 23, 2012, the gap between the earnings yield on stocks (the inverse of the broad market lagged P/E ratio and the yield on BAA corporate bonds) was wider than in more than 96% of the days since the start of 1986. Meanwhile, through the end of July, investors have added a net $177 billion to bond mutual funds while withdrawing $40 billion from stock mutual funds, according to the Investment Company Institute.

[2] See An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022, Congressional Budget Office, August 22, 2012.

The fiscal choice: Cliff, ledge or ladder

The federal budget and how we got here

Before looking at Washington's fiscal choices going into 2013, it is important to understand the basic math behind the federal budget. Three things should be noted before going any further:

- First, the deficit is the gap between government spending and revenues in any one fiscal year. Fiscal years run from October 1 of the prior year to September 30 of the current year and, as an approximation[3], the debt grows by the amount of the deficit each year.
- Second, in measuring the impact of deficits and debt, we look at these numbers relative to GDP, the overall output of goods and services in the economy. The key issue, when it comes to fiscal sustainability, is the size of debt and deficits relative to the overall economy.
- Third, in measuring the total debt, we look at what is known as "debt held by the public," currently $11.2 trillion, rather than "total public debt subject to limit," which currently amounts to $15.9 trillion. "Debt held by the public" excludes money the federal government owes to its own trust funds, most notably, the Social Security trust fund. This measure is the focus of most debt projections and we believe is a better measure to use in assessing both the sustainability of debt and its impact on global financial markets.

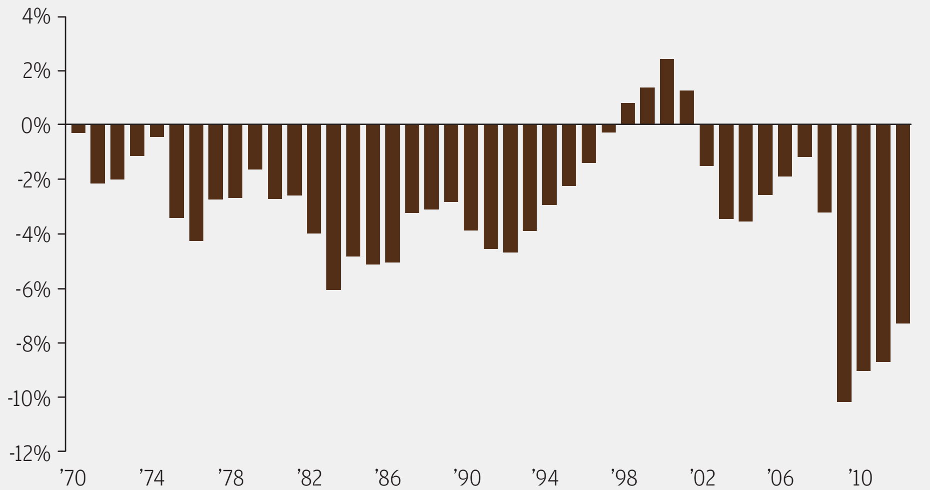
Bearing this in mind, Chart A shows the evolution of federal government budget deficits over the past 40 years, while Chart B shows the impact of these deficits on the federal debt. The economy experienced high deficits in the early 1980s, reflecting the impacts of a deep recession and a combination of a defense buildup and tax cuts. However, from the mid-1980s to the year 2000, the fiscal situation improved substantially with only one recession, a strong stock market and the impact of the end of the Cold War on defense spending. By 2000, the federal budget was in surplus and the debt/GDP ratio was falling rapidly.

Since then, America has experienced a series of shocks and slumps. Two wars, two recessions and two huge bear markets in stocks led to a surge in the deficit, as did attempts by both the Bush and Obama administrations to "stimulate" the economy through tax cuts and increased government spending. By fiscal 2009, the deficit had climbed to $1.416 trillion or 10.1% of GDP, with federal debt rising sharply.

Over the last three years, the deficit has retreated somewhat, with the CBO estimating a deficit of $1.128 trillion, or 7.3% of GDP, for the current fiscal year. While this does represent some progress, we estimate that the deficit would need to fall to below 4% in order for the debt to grow less quickly than GDP, thus stabilizing the debt/GDP ratio, albeit at a high level.

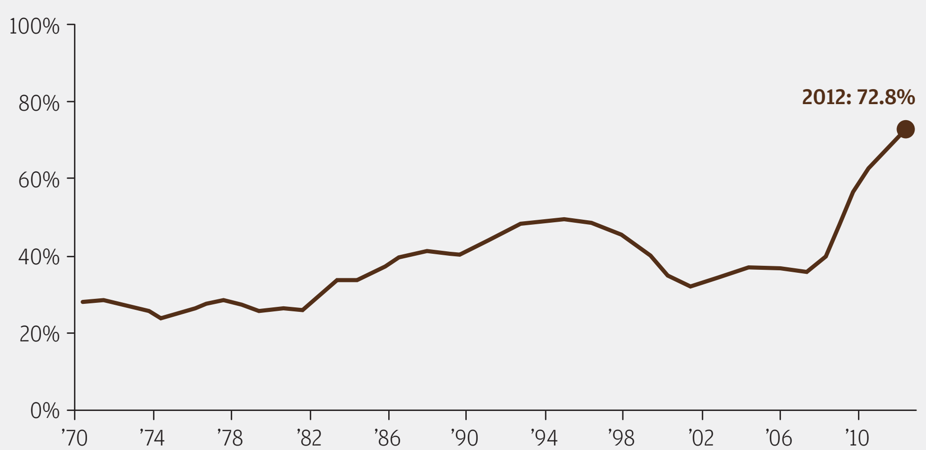
[3] This isn't actually exact because of changes in federal assets from year to year.

CHART A: Federal deficits
Federal deficit as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management.
1970 through 2011 numbers are actuals. 2012 Federal deficit based on the CBO's August 2012 projections.
Data are as of 8/28/12.

CHART B: Federal debt
Federal debt held by the public as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management.
1970 through 2011 numbers are actuals. 2012 Federal debt based on the CBO's August 2012 projections.
Data are as of 8/28/12.

The fiscal cliff

Remarkably, we are currently on track to reach these levels as early as next year. The "Baseline Forecast" of the Congressional Budget Office, portrayed in Charts C and D, assumes that current law prevails over the forecast period.

Under current law, as of December 31, 2012:

- All the Bush tax cuts are set to expire. This would, among other things, boost the top tax rate on ordinary income from 35% to 39.6%, increase the tax on dividends from 15% to 39.6%, increase the tax on long-term capital gains from 15% to 20% and increase the estate tax rate from 35% to 55%, with the exemption amount falling from more than $5 million to more than $1 million.
- The 2% payroll tax cut is set to expire.
- The extra 0.9% Medicare tax for upper-income households and the broadening of the Medicare tax base to include investment income for the same households is set to take effect.
- The extended unemployment benefit program is set to expire.
- The two rounds of discretionary spending cuts agreed to in August 2011 take effect, first adhering to formal caps on discretionary spending over the next decade, and then further reducing this spending due to the failure of the so-called "super committee" to agree on an alternative deficit reduction plan.

On paper, if all of this were implemented, it could reduce the deficit substantially; in practice, it would likely push the economy into a new recession as consumers reduced spending in reaction to lower after-tax income, the stock market fell in response to higher dividend and capital gains taxes and reduced government spending increased layoffs throughout the economy.

The charts below show the impact of these policies. The deficit would fall from 7.3% of GDP in fiscal 2012 to 4.0% of GDP in fiscal 2013 and 2.4% of GDP in fiscal 2014. In calendar years, the drop in the deficit would be more severe from 7.0% of GDP in 2012 to 3.1% of GDP in 2013, imparting a 3.9% of GDP "fiscal drag" on the U.S. economy. This would very likely lead to another recession.

Four scenarios after the election

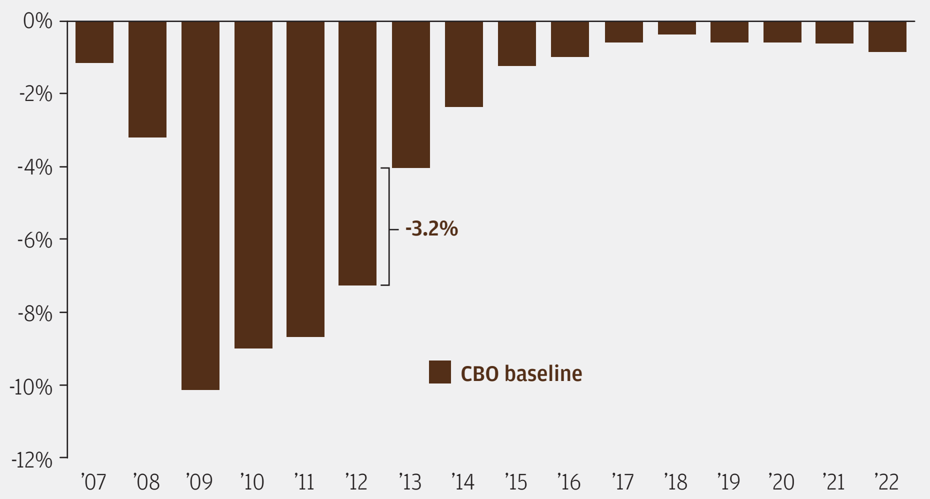
Most politicians of both major parties recognize the basic nature of this problem. However, for political reasons, no legislation to avoid the fiscal cliff is likely to be enacted before the election. After the election, action is likely but what type of action depends on the balance of power determined by the voters.

Before going any further, it is worth considering what that balance of power might be. As of right now, just over two months before election day, there are three realistic scenarios: a Democratic sweep of Congress and the White House, a Republican sweep of Congress and the White House or a divided government in which the president is re-elected but Republicans at least retain control of the House of Representatives. (A fourth scenario, whereby Mitt Romney is elected president but the Democrats at least retain control of the Senate seems less likely based on polling.)

Given these potential political outcomes, we outline four separate fiscal outcomes in the pages ahead:

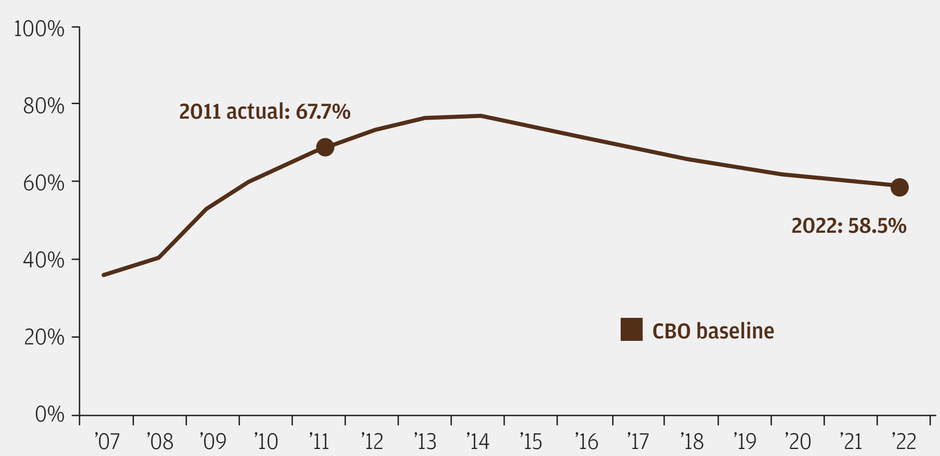
- The Democratic sweep: Bush tax cuts end for upper-income households
- The Republican sweep: A focus on spending cuts
- Divided government I: The fiscal ledge
- Divided government II: The fiscal ladder

CHART C: Federal deficits
Projected federal deficit as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management.
Data are as of 8/28/12.

CHART D: Federal debt
Projected federal debt held by the public as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management.
Data are as of 8/28/12.

The Democratic sweep: Bush tax cuts end for upper-income households

Assumptions

If President Obama is re-elected and his victory is big enough to achieve control of both the Senate and the House, it can be assumed that taxes will rise for upper-income Americans. In this scenario, we assume:

- The Bush tax cuts are extended only for households earning less than $250,000 per year along with the annual AMT fix. The top dividend tax and capital gains tax rates rise from 15% to 20%.
- The payroll tax cut is phased down to a 1% cut for 2013 through 2015 and eliminated from 2016 on in order to mitigate the fiscal drag from the partial expiration of the Bush tax cuts.
- Extended unemployment benefits expire on schedule.
- Higher Medicare taxes to pay for President Obama's health care plan take effect.
- Only the first round of spending cuts agreed to last fall are implemented. The second round does not take effect.

Economic effects & investment implications

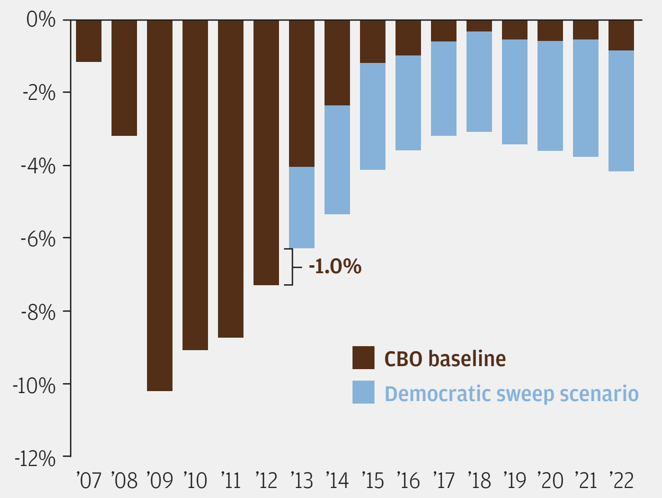
The table and charts on the following page show the impact of these policies on the budget and the economy.

From an investment perspective, the good news is that this scenario would only impose a moderate fiscal drag on the economy, with the budget deficit falling from 7.3% of GDP in fiscal 2012 to 6.3% of GDP in fiscal 2013 and 5.3% in 2014. On a calendar year basis, the fiscal drag is similar, with the deficit falling from 7.0% of GDP this year to 6.0% next year. (In all these scenarios we assume a multiplier of 1 so a deficit increase of 1% leads to 1% more nominal GDP.)

On the negative side, the combination of higher income taxes on dividends and capital gains and the imposition of a 3.8% Medicare tax on these sources of income would amount to a significant reduction in the after-tax cash flow from equities. It is uncertain whether relief from avoiding a sharper dose of fiscal austerity would offset the impact of these tax hikes in investor decisions. It could be a positive for municipal bonds as the value of the tax breaks on municipals would increase and smaller cutbacks in discretionary spending would have less of an impact on state and local finances.

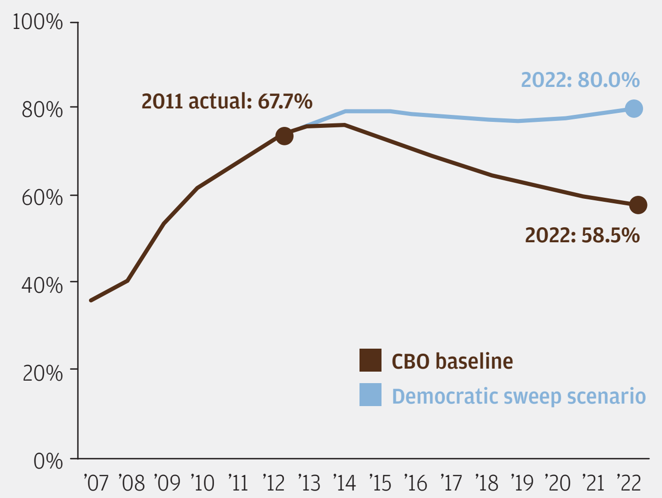
The Democratic sweep scenario

CHART E1: Federal deficits
Projected federal deficit as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management. Data are as of 8/28/12.

CHART E2: Federal debt
Projected federal debt held by the public as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management. Data are as of 8/28/12.

TABLE E3: Democratic sweep scenario

Fiscal Year	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22
CBO Baseline Deficit, billions $	**-$1,128**	**-$641**	**-$387**	**-$213**	**-$186**	**-$123**	**-$79**	**-$130**	**-$142**	**-$144**	**-$213**
Adjustments:											
Extend Expiring Tax Provisions, Lower Foreign Troops & "Doc Fix"	-	-72	-71	-40	-23	-13	-8	-6	-10	-16	-24
Interest Cost	-	*0*	*-1*	*-1*	*-3*	*-5*	*-7*	*-8*	*-9*	*-11*	*-13*
Partial Extension of Bush Tax Cuts and AMT Fix	-	-205	-280	-309	-332	-357	-384	-413	-443	-475	-510
Interest Cost	-	*-1*	*-3*	*-5*	*-15*	*-31*	*-56*	*-80*	*-105*	*-132*	*-161*
Extend Payroll Tax Cut	-	-44	-60	-62	-16	0	0	0	0	0	0
Interest Cost	-	*0*	*-2*	*-3*	*-4*	*-4*	*-4*	*-4*	*-4*	*-4*	*-4*
Automatic Enforcement (BCA) does not occur	-	-54	-96	-102	-104	-105	-105	-105	-105	-104	-93
Interest Cost	-	*0*	*-1*	*-2*	*-5*	*-10*	*-17*	*-24*	*-30*	*-37*	*-43*
Cumulative Cost	-	-375	-507	-513	-474	-475	-497	-524	-557	-595	-628
Cumulative Interest Cost	-	-1	-6	-12	-26	-49	-83	-116	-148	-184	-221
Total	**-**	**-376**	**-513**	**-525**	**-500**	**-525**	**-580**	**-640**	**-705**	**-779**	**-849**
Revised Deficit	**-$1,128**	**-$1,017**	**-$900**	**-$738**	**-$686**	**-$648**	**-$660**	**-$770**	**-$847**	**-$923**	**-$1,062**
% of GDP	**-7.3%**	**-6.3%**	**-5.3%**	**-4.1%**	**-3.6%**	**-3.2%**	**-3.1%**	**-3.4%**	**-3.6%**	**-3.8%**	**-4.2%**

The Republican sweep: A focus on spending cuts

Assumptions

If Mitt Romney is elected president and the Republicans maintain control of the House and take control of the Senate, the focus of deficit reduction would likely be on spending cuts. In this scenario we assume:

- All the Bush tax cuts are extended along with the annual AMT fix.
- The payroll tax cut and extended unemployment benefits expire on schedule.
- Higher Medicare taxes to pay for President Obama's health care plan do not take effect.
- Only the first round of spending cuts agreed to last fall are implemented. The second round does not take effect.

Economic effects & investment implications

The table and charts on the following page show the impact of these policies on the budget and the economy. The budget deficit falls from 7.3% of GDP in fiscal 2012 to 6.4% of GDP in fiscal 2013 and 5.3% in 2014. On a calendar year basis, the decline is similar – from 7.0% of GDP this year to 6.2% next year.

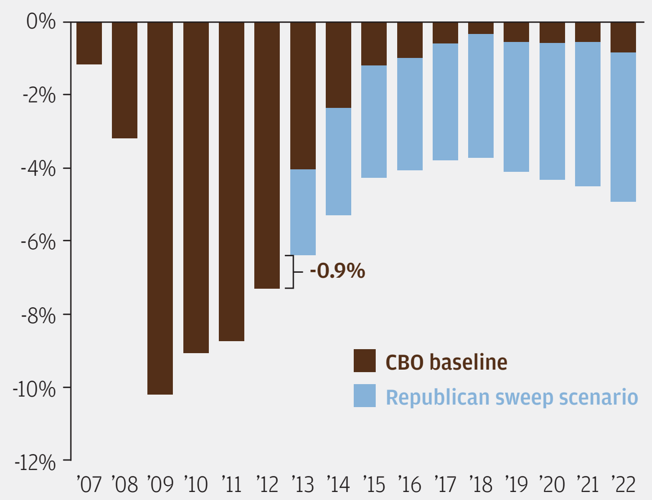
This scenario, like the Democratic sweep scenario, would impose only moderate fiscal drag on the overall economy.

It should be noted that this scenario would probably only be a starting point. If there were a Republican sweep of the White House and Congress, a Romney administration might also try to pass both tax reform and entitlement reform in 2013. It is also worth noting that stabilizing the debt to GDP ratio should only be an interim goal as it would leave the budget very vulnerable to another recession, another war or even a sharp increase in interest rates.

For investors, an all-Republican administration could favor stocks relative to bonds. In particular, removing the threat of higher taxation on dividends and capital gains should help the stock market more than removing the threat of higher taxes on interest income. However, it could be a negative for municipal bonds, as the value of the tax break on municipals would not be as great and cuts in discretionary spending could have knock-on effects on state and local finances.

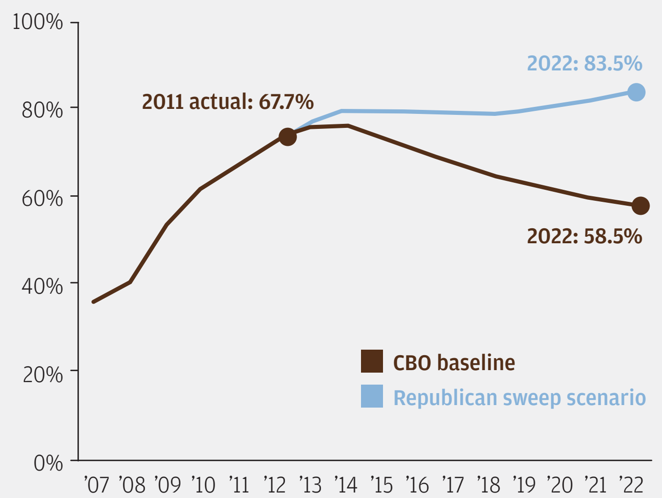
The Republican sweep scenario

CHART F1: Federal deficits
Projected federal deficit as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management. Data are as of 8/28/12.

CHART F2: Federal debt
Projected federal debt held by the public as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management. Data are as of 8/28/12.

TABLE F3: Republican sweep scenario

Fiscal Year	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22
CBO Baseline Deficit, billions $	**-$1,128**	**-$641**	**-$387**	**-$213**	**-$186**	**-$123**	**-$79**	**-$130**	**-$142**	**-$144**	**-$213**
Adjustments:											
Extend Expiring Tax Provisions, Lower Foreign Troops & "Doc Fix"	-	-72	-71	-40	-23	-13	-8	-6	-10	-16	-24
Interest Cost	-	*0*	*-1*	*-1*	*-3*	*-5*	*-7*	*-8*	*-9*	*-11*	*-13*
Full Extension of Bush Tax Cuts and AMT Fix	-	-247	-319	-372	-404	-439	-474	-511	-548	-588	-630
Interest Cost	-	*-1*	*-3*	*-6*	*-18*	*-37*	*-68*	*-97*	*-128*	*-161*	*-197*
Repeal of the Expanded Medicare Tax	-	-20	-10	-25	-29	-32	-35	-38	-41	-43	-46
Interest Cost	-	*0*	*-1*	*-1*	*-2*	*-2*	*-3*	*-4*	*-5*	*-5*	*-6*
Automatic Enforcement (BCA) does not occur	-	-54	-96	-102	-104	-105	-105	-105	-105	-104	-93
Interest Cost	-	*0*	*-1*	*-2*	*-5*	*-10*	*-17*	*-24*	*-30*	*-37*	*-43*
Cumulative Cost	-	-393	-495	-540	-560	-589	-622	-660	-703	-750	-793
Cumulative Interest Cost	-	-1	-5	-11	-27	-54	-94	-133	-172	-215	-259
Total	**-**	**-394**	**-501**	**-550**	**-586**	**-643**	**-717**	**-793**	**-875**	**-965**	**-1053**
Revised Deficit	**-$1,128**	**-$1,035**	**-$888**	**-$763**	**-$772**	**-$766**	**-$796**	**-$923**	**-$1,017**	**-$1,109**	**-$1,266**
% of GDP	**-7.3%**	**-6.4%**	**-5.3%**	**-4.2%**	**-4.0%**	**-3.8%**	**-3.7%**	**-4.1%**	**-4.3%**	**-4.5%**	**-4.9%**

Divided government I: The fiscal ledge

Assumptions

Even in the case of divided government, an outright fiscal cliff is unlikely. However, there is a significant risk that a compromise could involve an agreement to abide by significant spending cuts (to satisfy the Republicans) along with higher taxes on upper income households (to get agreement from the Democrats). Under this scenario, we assume:

- The Bush tax cuts are extended only for households earning less than $250,000 per year along with the annual AMT fix. The top dividend tax and capital gains tax rates rise from 15% to 20%.
- The payroll tax cut expires on schedule.
- Extended unemployment benefits expire on schedule.
- Higher Medicare taxes to pay for President Obama's health care plan do take effect.
- Both sets of spending cuts agreed to last fall are implemented.

Economic effects & investment implications

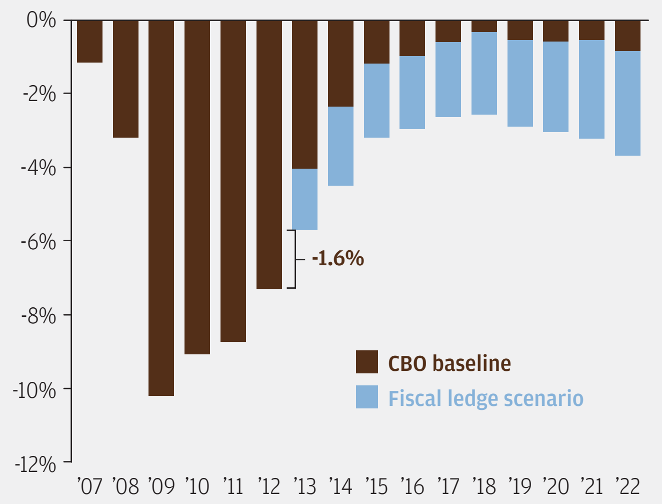
The table and charts on the following page show the impact of these policies on the budget and the economy. Under this scenario, the budget deficit falls very sharply from 7.3% of GDP this fiscal year to 5.7% next fiscal year and 4.4% in fiscal 2013. In calendar years, the deficit would fall from 7.0% of GDP this year to 5.3% next year and 4.2% of GDP in 2013.

This is probably the greatest fiscal danger facing the economy, simply because most voters and investors don't recognize its implications. We estimate that in calendar 2012, the deficit as a share of GDP will fall by about 1.3 percentage points and that this decline has had a major impact in holding real GDP growth to an anemic 2.1%. A compromise that cut the deficit by a more severe 1.7 percentage points in 2013 could push the economy to the brink of recession entirely unnecessarily.

Under a fiscal ledge scenario, even if the economy avoided outright recession, stocks would be negatively affected by a combination of very weak economic growth and higher taxes on dividends and capital gains. Treasury yields might well stay at close to current levels, although a further bond market rally might not materialize as investors recognized that Washington was incapable of fostering economic growth by a moderate reduction in federal deficits.

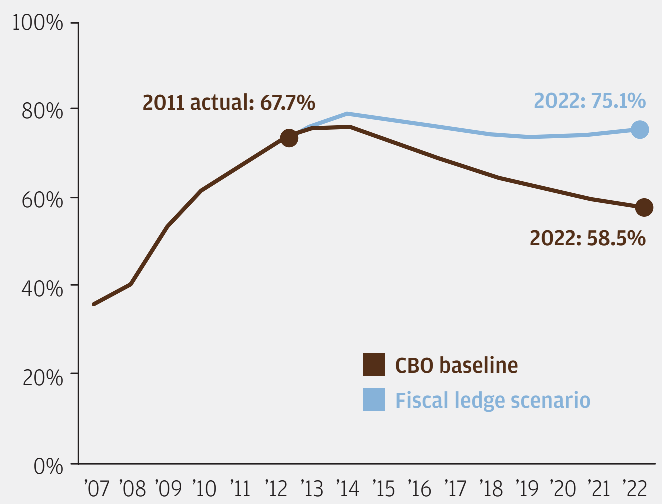
Divided government: Fiscal ledge scenario

CHART G1: Federal deficits
Projected federal deficit as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management. Data are as of 8/28/12.

CHART G2: Federal debt
Projected federal debt held by the public as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management. Data are as of 8/28/12.

TABLE G3: Fiscal ledge scenario

Fiscal Year	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22
CBO Baseline Deficit, billions $	**-$1,128**	**-$641**	**-$387**	**-$213**	**-$186**	**-$123**	**-$79**	**-$130**	**-$142**	**-$144**	**-$213**
Adjustments:											
Extend Expiring Tax Provisions, Lower Foreign Troops & "Doc Fix"	-	-72	-71	-40	-23	-13	-8	-6	-10	-16	-24
Interest Cost	-	*0*	*-1*	*-1*	*-3*	*-5*	*-7*	*-8*	*-9*	*-11*	*-13*
Partial Extension of Bush Tax Cuts and AMT Fix	-	-205	-280	-309	-332	-357	-384	-413	-443	-475	-510
Interest Cost	-	*-1*	*-3*	*-5*	*-15*	*-31*	*-56*	*-80*	*-105*	*-132*	*-161*
Cumulative Cost	-	-276	-351	-349	-355	-370	-392	-420	-452	-491	-534
Cumulative Interest Cost	-	-1	-3	-7	-18	-36	-63	-88	-115	-143	-174
Total	**-**	**-277**	**-355**	**-356**	**-372**	**-406**	**-455**	**-508**	**-567**	**-635**	**-708**
Revised Deficit	**-$1,128**	**-$918**	**-$742**	**-$569**	**-$558**	**-$529**	**-$534**	**-$638**	**-$709**	**-$779**	**-$921**
% of GDP	**-7.3%**	**-5.7%**	**-4.4%**	**-3.2%**	**-2.9%**	**-2.6%**	**-2.5%**	**-2.9%**	**-3.0%**	**-3.2%**	**-3.6%**

Divided government II: The fiscal ladder

Assumptions

A better scenario is one in which the deficit comes down more slowly in 2013. Under this scenario we assume:

- The Bush tax cuts are extended in full for 2013. From 2014 on they are extended only for households earning less than $250,000 per year along with the annual AMT fix. The top dividend tax and capital gains tax rates rise from 15% to 20% in 2014.
- The payroll tax cut is maintained in 2014, phased down to a 1% cut for 2013 and eliminated for 2014 on in order to mitigate the fiscal drag from the partial expiration of the Bush tax cuts.
- Extended unemployment benefits expire on schedule.
- Higher Medicare taxes to pay for President Obama's health care plan do take effect.
- Only the first round of spending cuts agreed to last fall are implemented. The second round does not take effect.

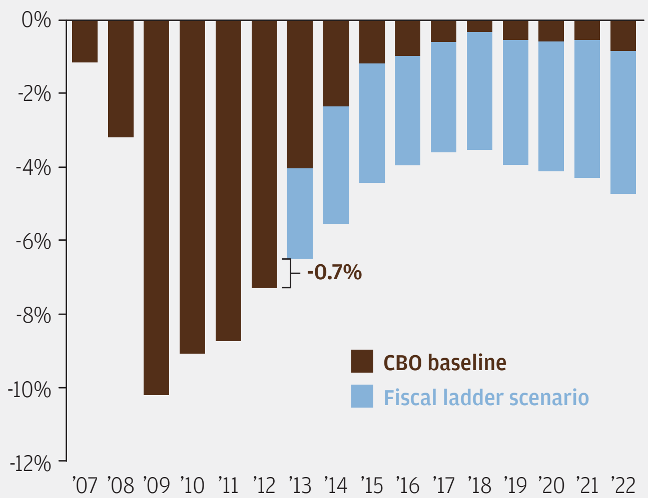
Economic effects & investment implications

Under this scenario, the budget deficit falls moderately from 7.3% of GDP this fiscal year to 6.5% next fiscal year, 5.5% in fiscal 2015 and 4.5% in fiscal 2016. In calendar years, the deficit would gradually fall from 7.0% of GDP this year to 4.2% of GDP in 2016.

The stock market would be negatively impacted by higher taxes on dividends and capital gains. However, by fostering economic growth while gradually reducing the deficit, this scenario could enhance investor confidence. It would likely be a negative for Treasury bonds as more responsible fiscal policies could set the stage for a gradual tightening by the Federal Reserve. Municipal bonds could potentially fare better than Treasuries because of reduced credit risk and the enhanced value of tax exemption for upper income households.

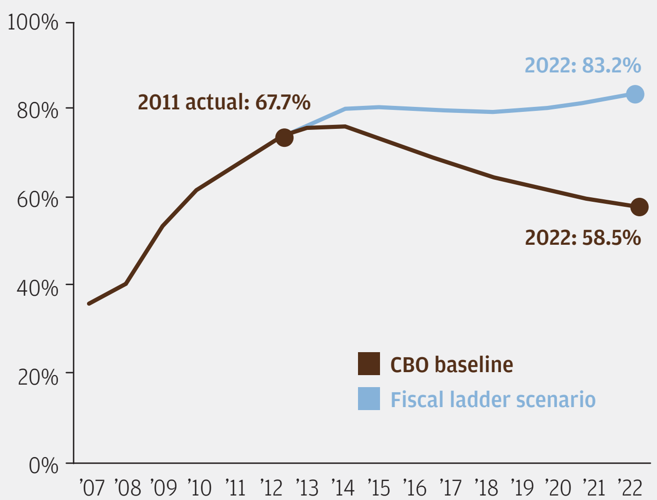
Divided government: Fiscal ladder scenario

CHART H1: Federal deficits
Projected federal deficit as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management. Data are as of 8/28/12.

CHART H2: Federal debt
Projected federal debt held by the public as a % of GDP



Sources: Congressional Budget Office, U.S. Treasury, BEA, J.P. Morgan Asset Management. Data are as of 8/28/12.

TABLE H3: Fiscal ladder scenario

Fiscal Year	'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	'22
CBO Baseline Deficit, billions $	**-$1,128**	**-$641**	**-$387**	**-$213**	**-$186**	**-$123**	**-$79**	**-$130**	**-$142**	**-$144**	**-$213**
Adjustments:											
Extend Expiring Tax Provisions, Lower Foreign Troops & "Doc Fix"	-	-72	-71	-40	-23	-13	-8	-6	-10	-16	-24
Interest Cost	-	*0*	*-1*	*-1*	*-3*	*-5*	*-7*	*-8*	*-9*	*-11*	*-13*
Full Extension of Bush Tax Cuts and AMT Fix	-	-247	-319	-372	-404	-439	-474	-511	-548	-588	-630
Interest Cost	-	*-1*	*-3*	*-6*	*-18*	*-37*	*-68*	*-97*	*-128*	*-161*	*-197*
Partial Extension of Payroll Tax Cut	-	-44	-60	-62	-16	0	0	0	0	0	0
Interest Cost	-	*0*	*-2*	*-3*	*-4*	*-4*	*-4*	*-4*	*-4*	*-4*	*-4*
Automatic Enforcement (BCA) does not occur	-	-54	-96	-102	-104	-105	-105	-105	-105	-104	-93
Interest Cost	-	*0*	*-1*	*-2*	*-5*	*-10*	*-17*	*-24*	*-30*	*-37*	*-43*
Cumulative Cost	-	-417	-545	-577	-546	-557	-587	-622	-662	-707	-747
Cumulative Interest Cost	-	-1	-7	-13	-29	-56	-95	-133	-171	-213	-257
Total	**-**	**-418**	**-552**	**-589**	**-575**	**-612**	**-682**	**-755**	**-833**	**-920**	**-1004**
Revised Deficit	**-$1,128**	**-$1,059**	**-$939**	**-$802**	**-$761**	**-$735**	**-$762**	**-$885**	**-$975**	**-$1,064**	**-$1,217**
% of GDP	**-7.3%**	**-6.5%**	**-5.5%**	**-4.5%**	**-4.0%**	**-3.6%**	**-3.5%**	**-3.9%**	**-4.1%**	**-4.3%**	**-4.7%**

Conclusion

It must be said that all of these scenarios just represent a start. Even if the deficit comes down slowly, in the Democratic sweep, Republican sweep or fiscal ladder scenarios, the deficit would stabilize at about 4% of GDP by the middle of this decade. This would only be enough to cause the debt-to-GDP ratio to plateau at 80%+ of GDP, a level which is dangerously high given the possibility of any further recession or national emergency that could result in some future surge in the deficit. In addition, as both sides should acknowledge, the Federal budget is in chronic need of both tax reform and entitlement reform.

In the short run, we face a fiscal cliff and need a fiscal ladder. Investors would be well advised to watch the political winds to see if we get this ladder or something worse. They will also want to consider the mix of tax increases and spending cuts likely to take hold starting in 2013 in designing an appropriate and tax efficient investment strategy.

However, in the long run, the fiscal problem facing America requires budget reform so that our system of government can once again be a key competitive advantage rather than a growing disadvantage of the U.S. economy.

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