NATIONAL ASSOCIATION OF
Estate Planners & Councils

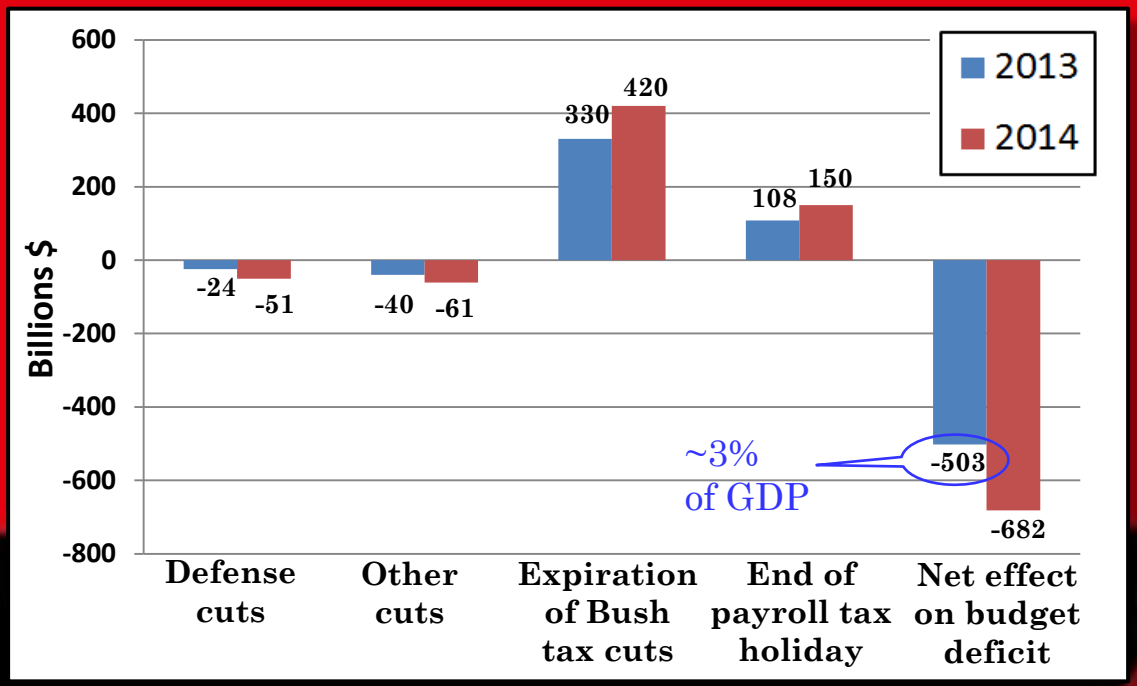
Estate Planning Council
Of Central Illiana, Inc.

What's Up With the Economy?

What's Down With the Economy?

- A few words about the fiscal cliff
- A brief assessment of our current economic situation
- Some (hopefully) rational observations on equity valuations
- An intrepid foray into macroeconomic forecasting

What's this I hear about a fiscal cliff?



- Shorthand for a group of policy changes that will come together around Jan. 1 – expiration of Bush-era tax cuts, automatic spending cuts ("Sequestration"), alternative minimum tax starts kicking in …
- Conventional wisdom assumes that Congress will do something constructive in a lame-duck session.
- In September, a Goldman Sachs research note said there was a 1 in 3 chance that Congress would fail to pass even short-term measures to avoid a cliff.

Or Is It More of a Slope?

Key Elements of the "Fiscal Slope":

- ✓ Expiration of the "Bush tax cuts" – reversion to marginal tax rates of 2000.
- ✓ Failure to enact a retroactive inflation adjustment for the Alternative Minimum Tax.
- ✓ Reversion to 2000 Estate Tax levels.
- ✓ Reinstitution of original payroll tax deductions (End of payroll tax "holiday").
- ✓ New taxes associated with the Patient Protection and Affordable Care Act of (a.k.a., "Obamacare") of 2010.
- ✓ "Sequestration" – automatic spending cuts.

2011

Married Filing Jointly

Marginal Tax Rate	Tax Brackets: Over	But Not Over
10.0%	$0	$17,000
15.0%	$17,000	$69,000
25.0%	$69,000	$139,350
28.0%	$139,350	$212,300
33.0%	$212,300	$379,150
35.0%	$379,150	-

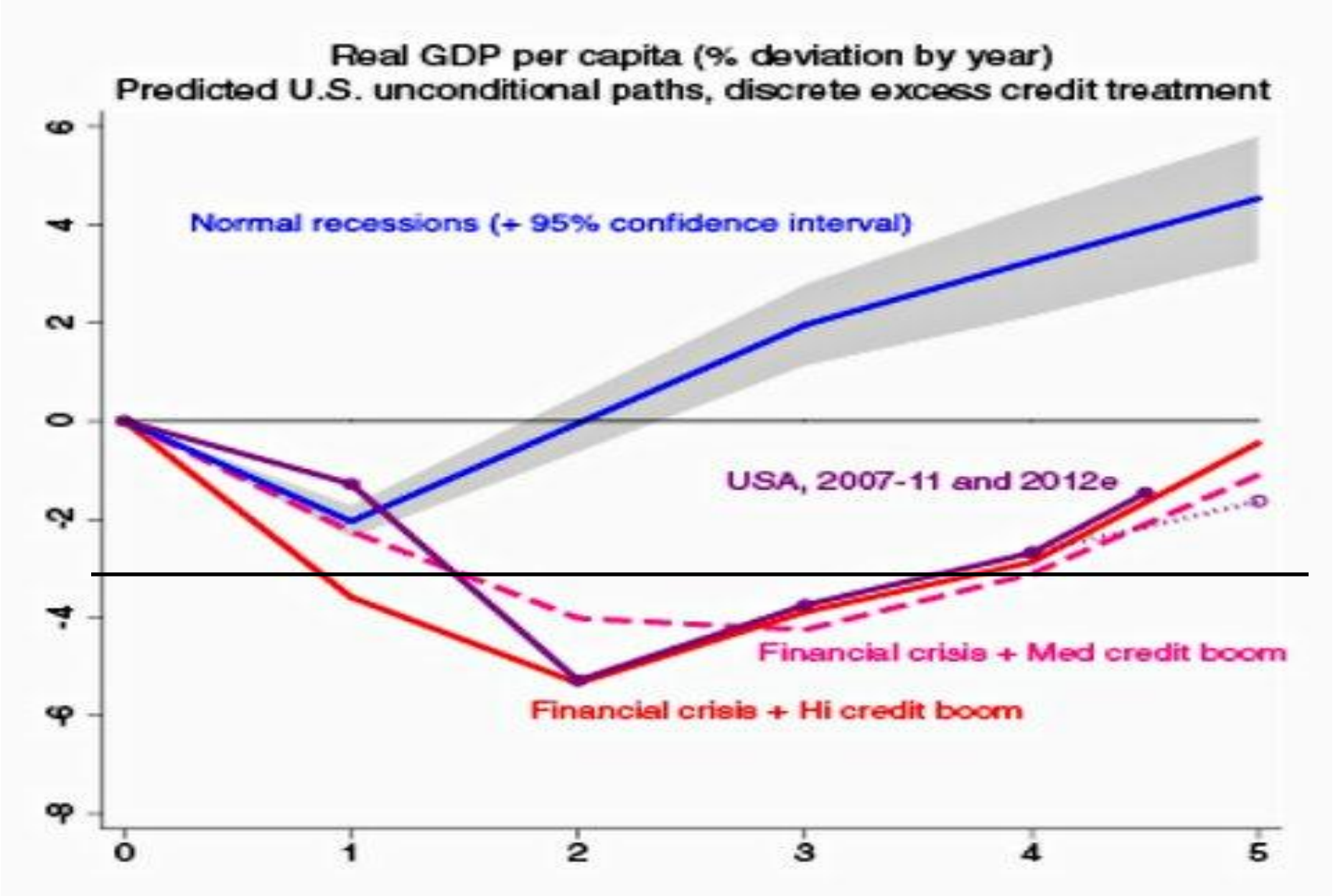
2000 (Adjusted for Inflation)

Married Filing Jointly

Marginal Tax Rate	Tax Brackets: Over	But Not Over
15.0%	$0	$57,137
28.0%	$57,137	$138,055
31.0%	$138,055	$210,372
36.0%	$210,372	$375,725
39.6%	$375,725	-

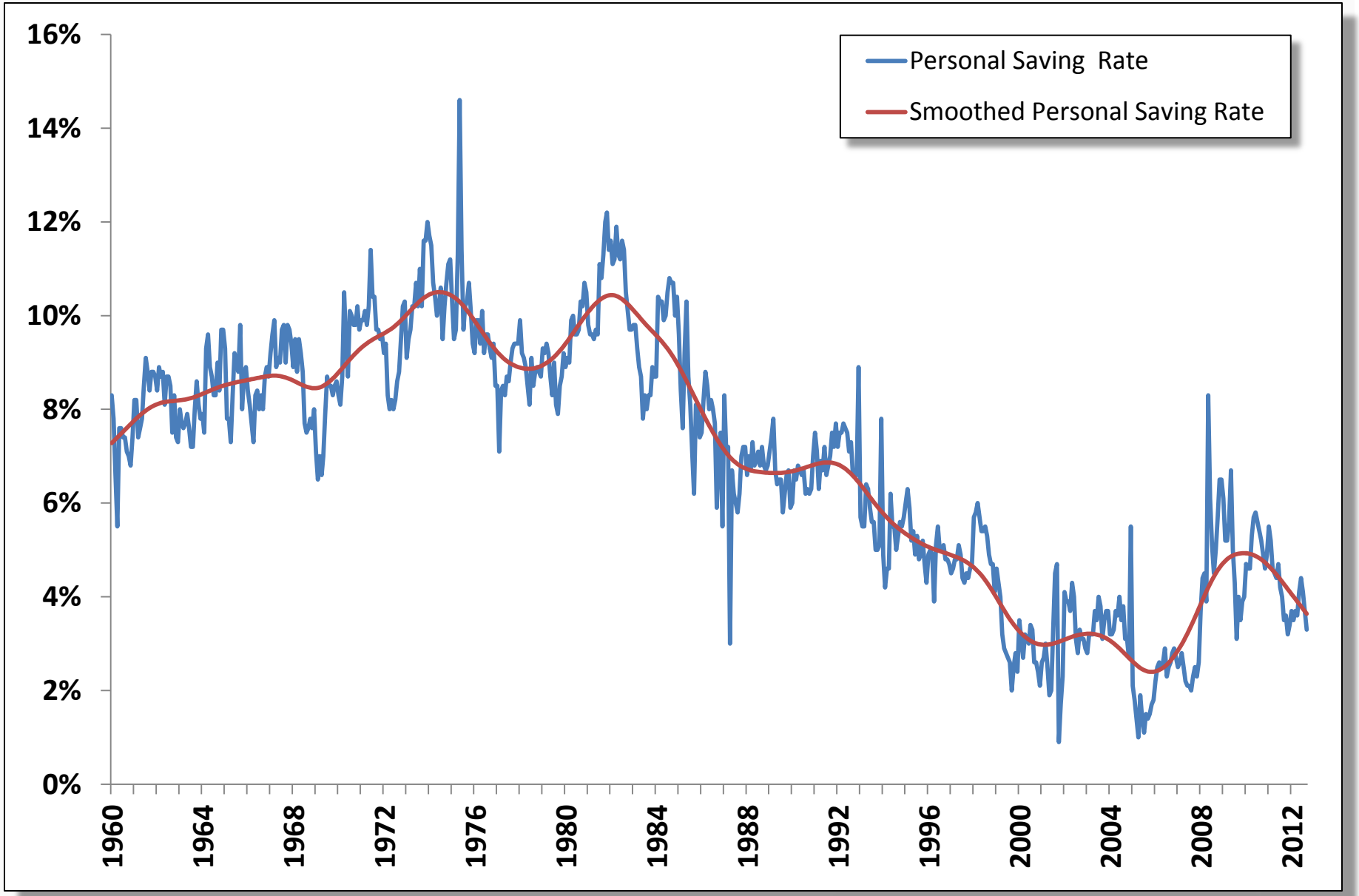

Not All Slopes Are the Same,
… And Sometimes We Get to Choose Our Way Down
And there is a
way back up!

The Long Road Back (From the 2008 – 2009 Recession)



Jordà, Òscar, Moritz Schularick, and Alan M. Taylor. 2011. "When Credit Bites Back: Leverage, Business Cycles, and Crises." NBER Working Papers 17621.

The Long Road Back



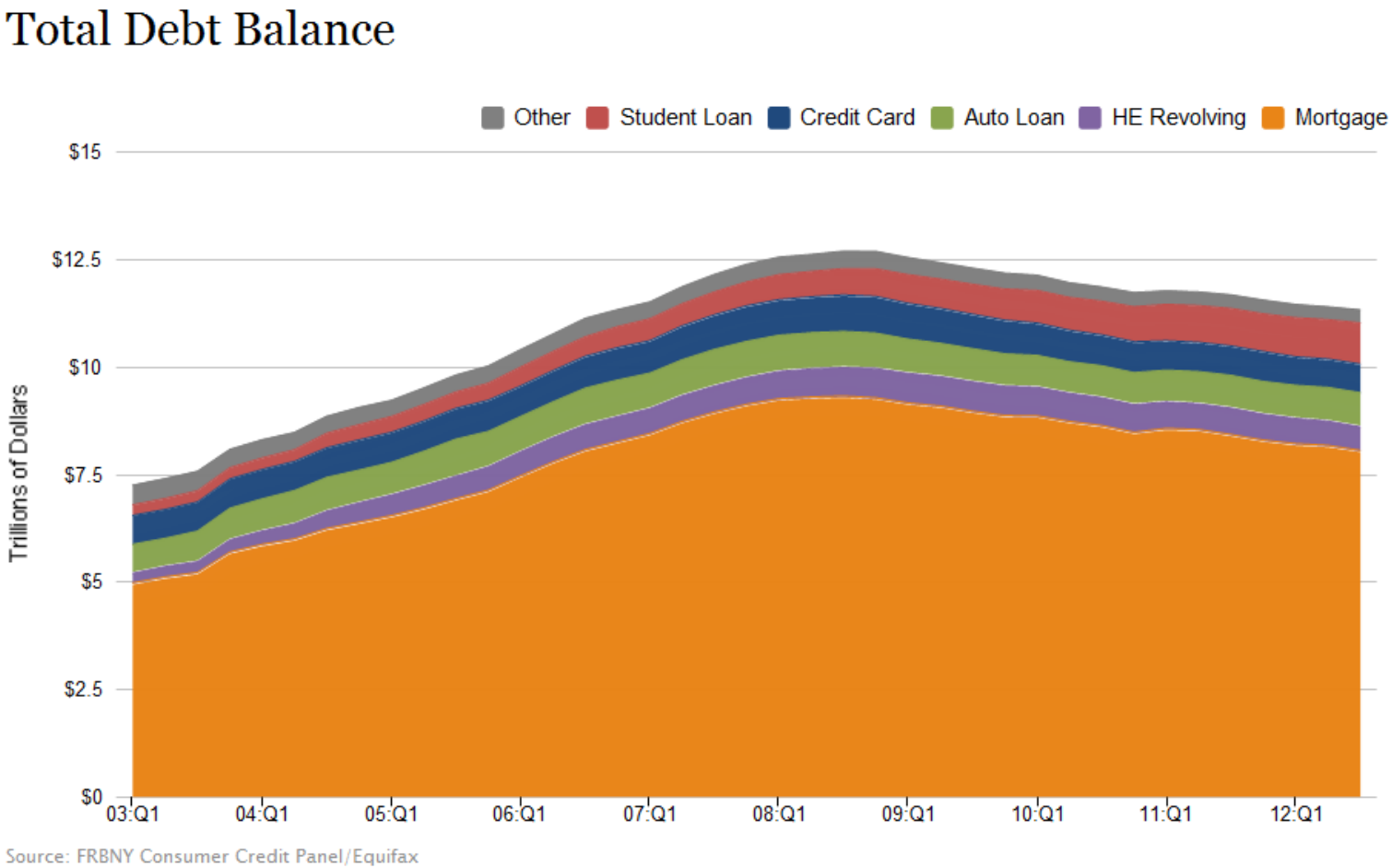
The Long Road Back

- We're experiencing a very slow recovery from a "balance sheet recession"
  - Richard Koo (2011), "The world in balance sheet recession: causes, cure, and politics." *Real-World Economics Review* 58, http://www.paecon.net/PAEReview/issue58/Koo58.pdf
  - Martin Wolf (2012), "Getting out of debt by adding debt." July 25, 2012, http://blogs.ft.com/martin-wolf-exchange/2012/07/25/getting-out-of-debt-by-adding-debt/#axzz27Ps9eoHx

- The "fiscal cliff" would amount to a shift to austerity by having the public sector deleverage while the private sector continue its own deleveraging. This could be detrimental to economic performance. Luckily, it's more of a "slope" than a "cliff"
  - Congressional Budget Office (2012), "Economic effects of reducing the fiscal restraint that is scheduled to occur in 2013." http://www.cbo.gov/sites/default/files/cbofiles/attachments/FiscalRestraint_0.pdf

- "… in a depressed economy like the present, if a long deep recession casts even a small shadow on future potential output, with interest rates in the range at which the U.S. has been able to borrow, there is a substantial likelihood that expansionary fiscal policy right now would be self-financing, and an overwhelming likelihood that it would pass a benefit-cost test.
  - Brad DeLong and Larry Summers, "Fiscal Policy in a Depressed Economy", Brookings Papers, March 22, 2012. http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2012_spring_bpea_papers/2012_spring_BPEA_delongsummers.pdf

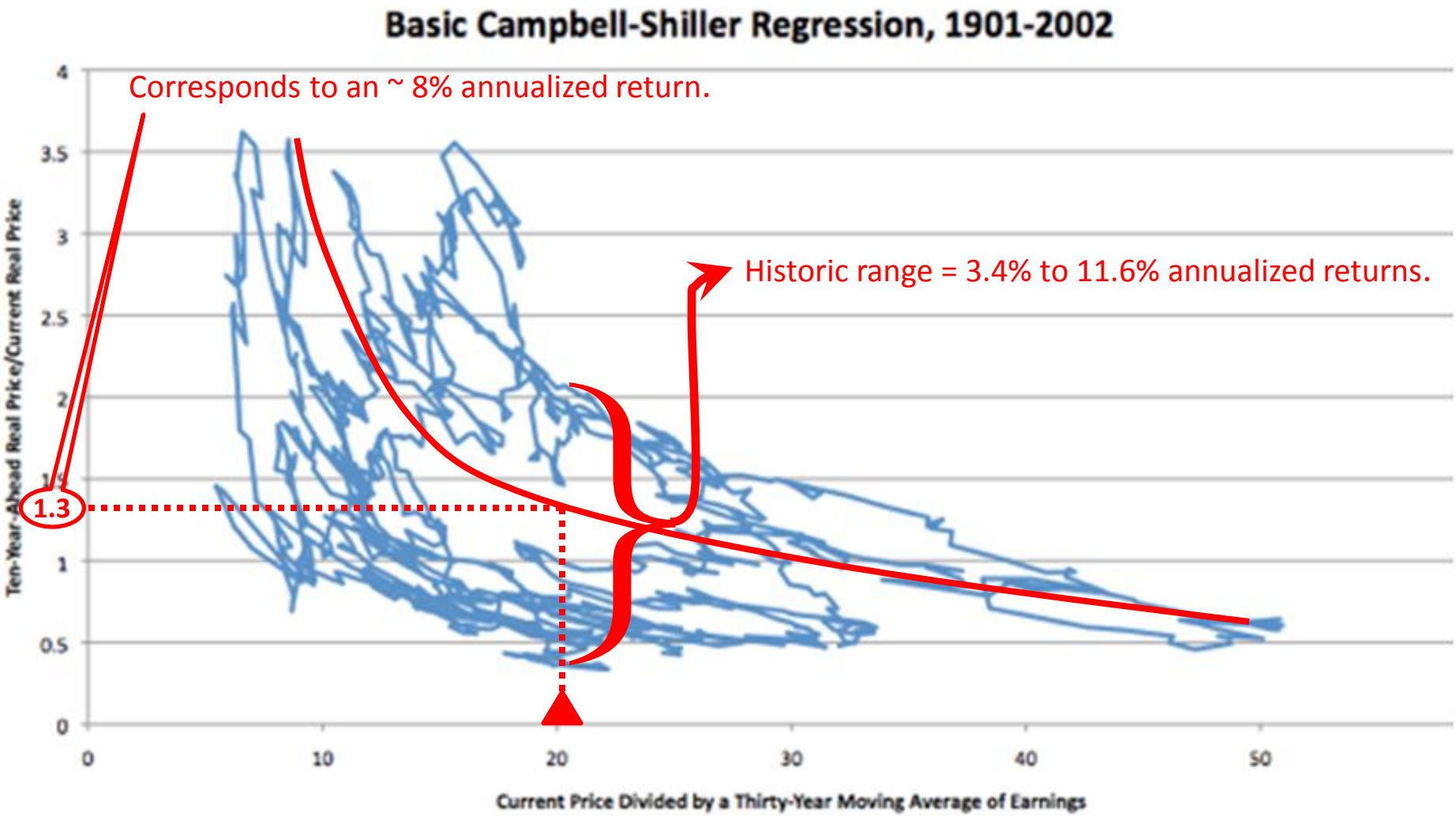
Evidence of a Balance Sheet Recession (and Recovery)



Aggregate consumer debt fell again in the third quarter, by $74 billion, continuing the nearly four-year downward trend in household debt. As of September 30, 2012, total consumer indebtedness was $11.31 trillion, 0.7% lower than its level in the second quarter of 2012 and down $1.37 trillion from the 2008Q3 peak.

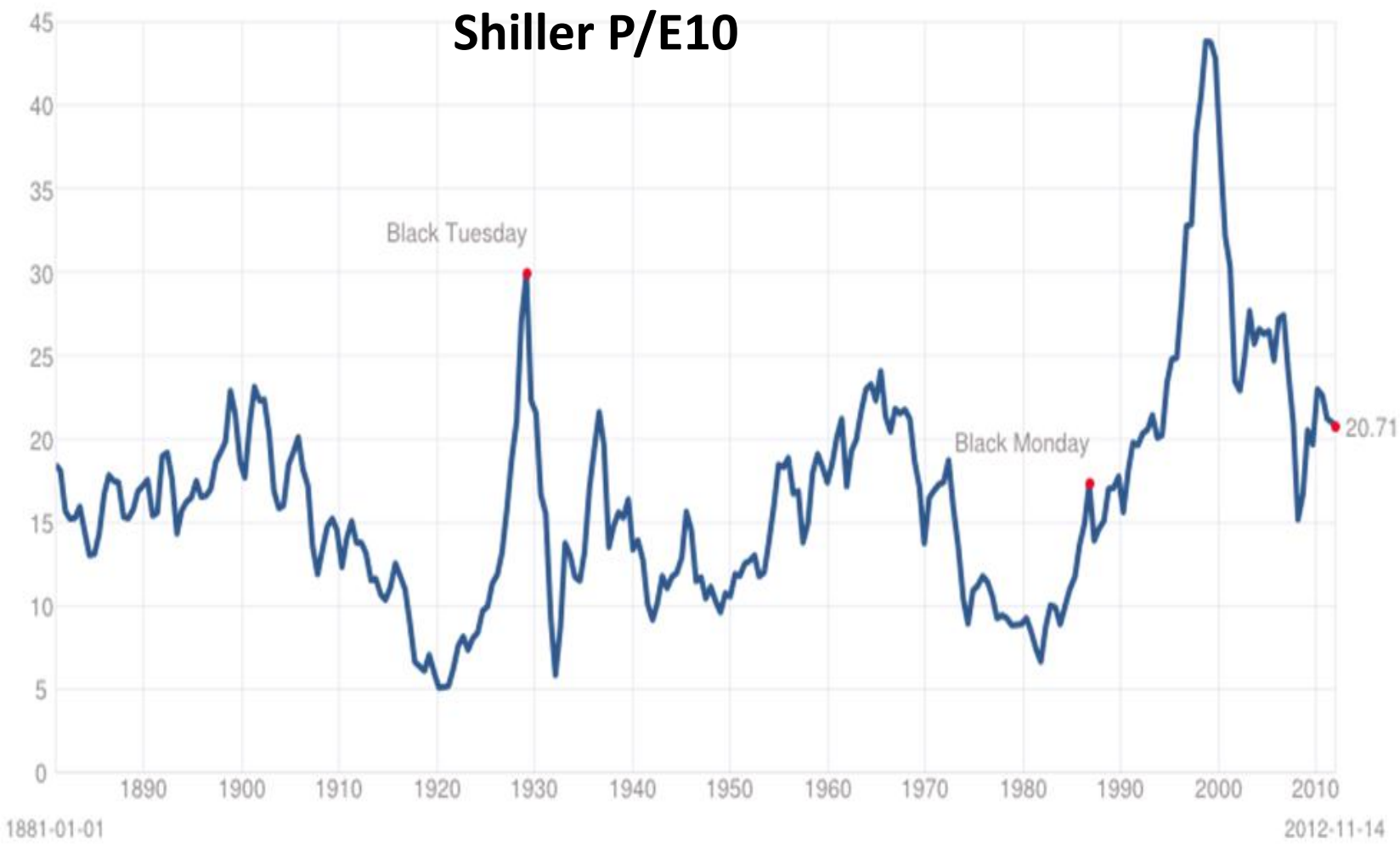
New York Federal Reserve, 2012 Q3 ***Quarterly Report on Household Debt and Credit*** , November 27,2012. (This page added 1 week after the presentation.)

A Very Brief Look at Equity Markets



http://delong.typepad.com/sdj/2012/10/campbell-shiller-regressions-future-sp-price-changes-regressed-on-ratios-of-prices-to-long-run-moving-averages-of-past-earn.html "This is a major, major, empirical win for Campbell and Shiller. This is why only fools say today that movements in market-wide price-earnings ratios are best interpreted as shifts in rational expectations of future earnings and dividend growth. Instead, they are best interpreted as due to fads and fashions in how much people are willing to nerve themselves to pay for a dollar of earnings today …"

A Very Brief Look at Equity Markets



http://www.multpl.com/shiller-pe/

Forecasting is not a strength of *any* economist, but that never stops us from trying …

The Crystal Ball Business

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Bold prediction for recovery

St. Louis Fed president sees 3.5 percent growth in 2013, but three other forecasters disagree.

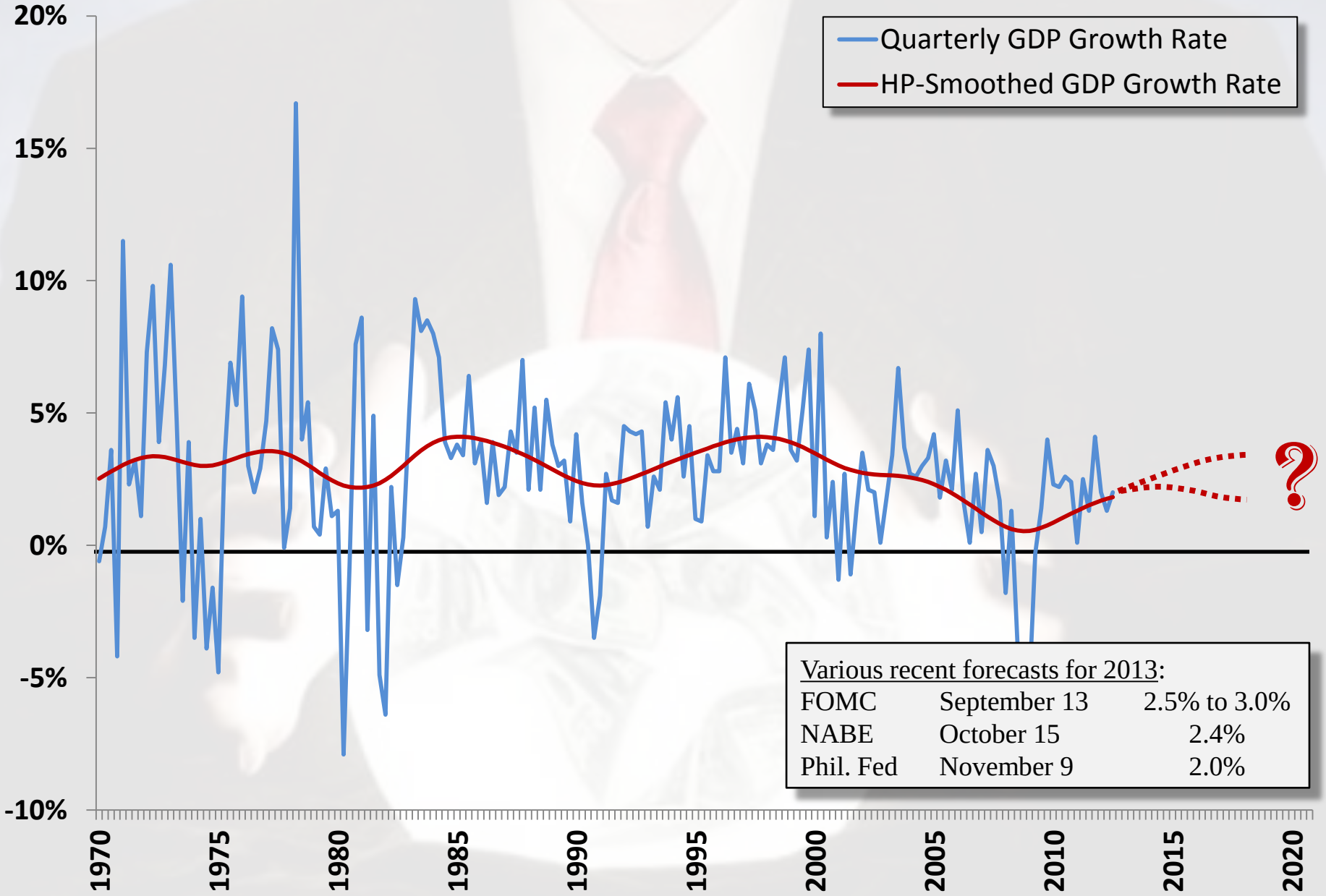
James Bullard, president of the St. Louis Federal Reserve Bank, told them he thinks the U.S. gross domestic product will grow 3.5 percent next year. While that's above average, it might not sound exceptional to an uninformed listener.

Bullard's forecast puts him at odds with most private-sector economists. Three other forecasters who joined Bullard at Monday's program said the economy remains stuck at a growth rate of just over 2 percent.

Bullard was, he admitted, too optimistic heading into 2011 and 2012. "We expected a faster re-bound" from the recession, he said. "There have been drag factors, primarily housing and the situation in Europe."

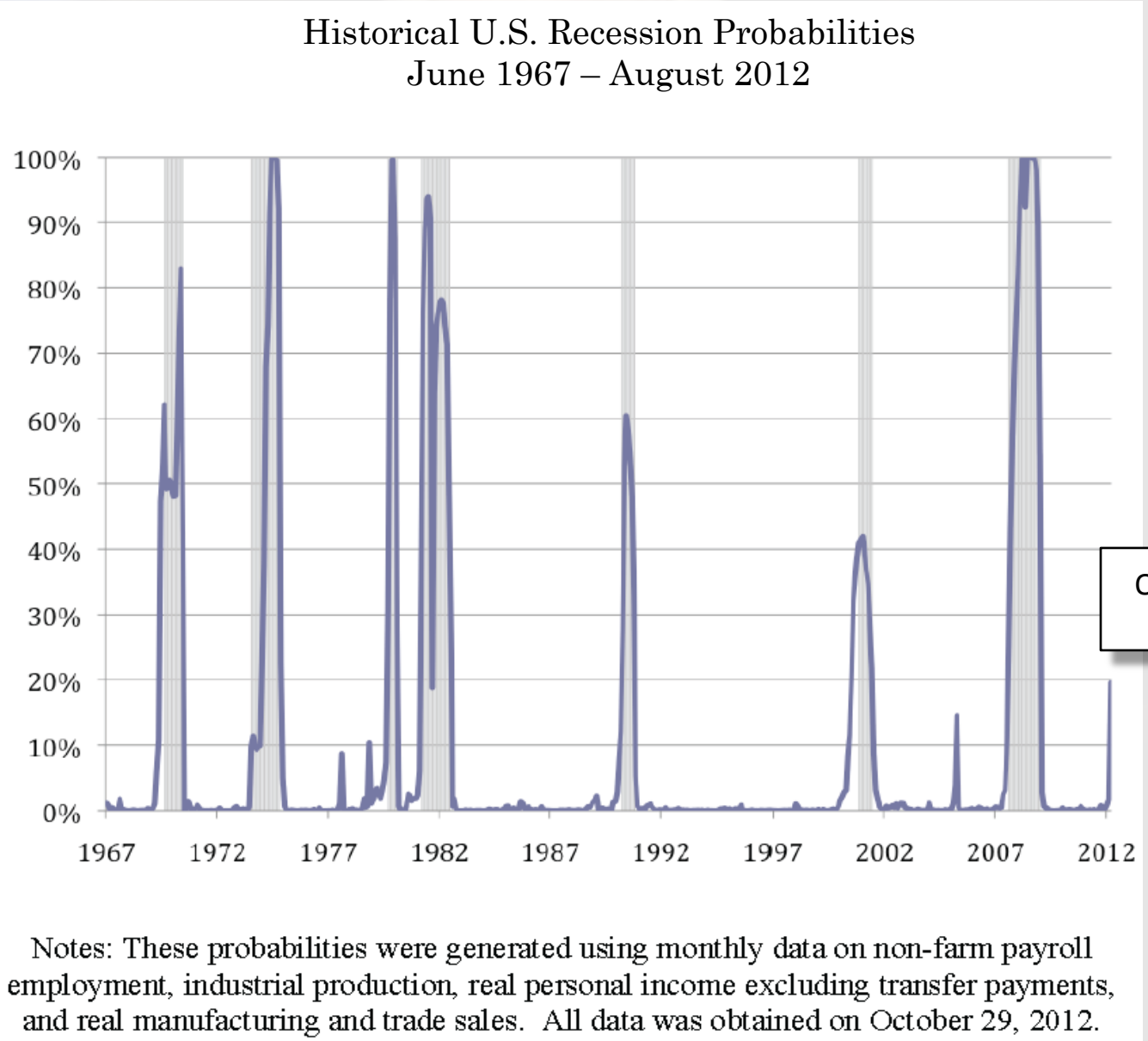
Now, housing is showing signs of recovery, and the European Central Bank seems committed to keeping the continent's banks afloat, no matter how many bail-outs the Spanish and Greek governments need.

U.S. Economic Growth Over Time



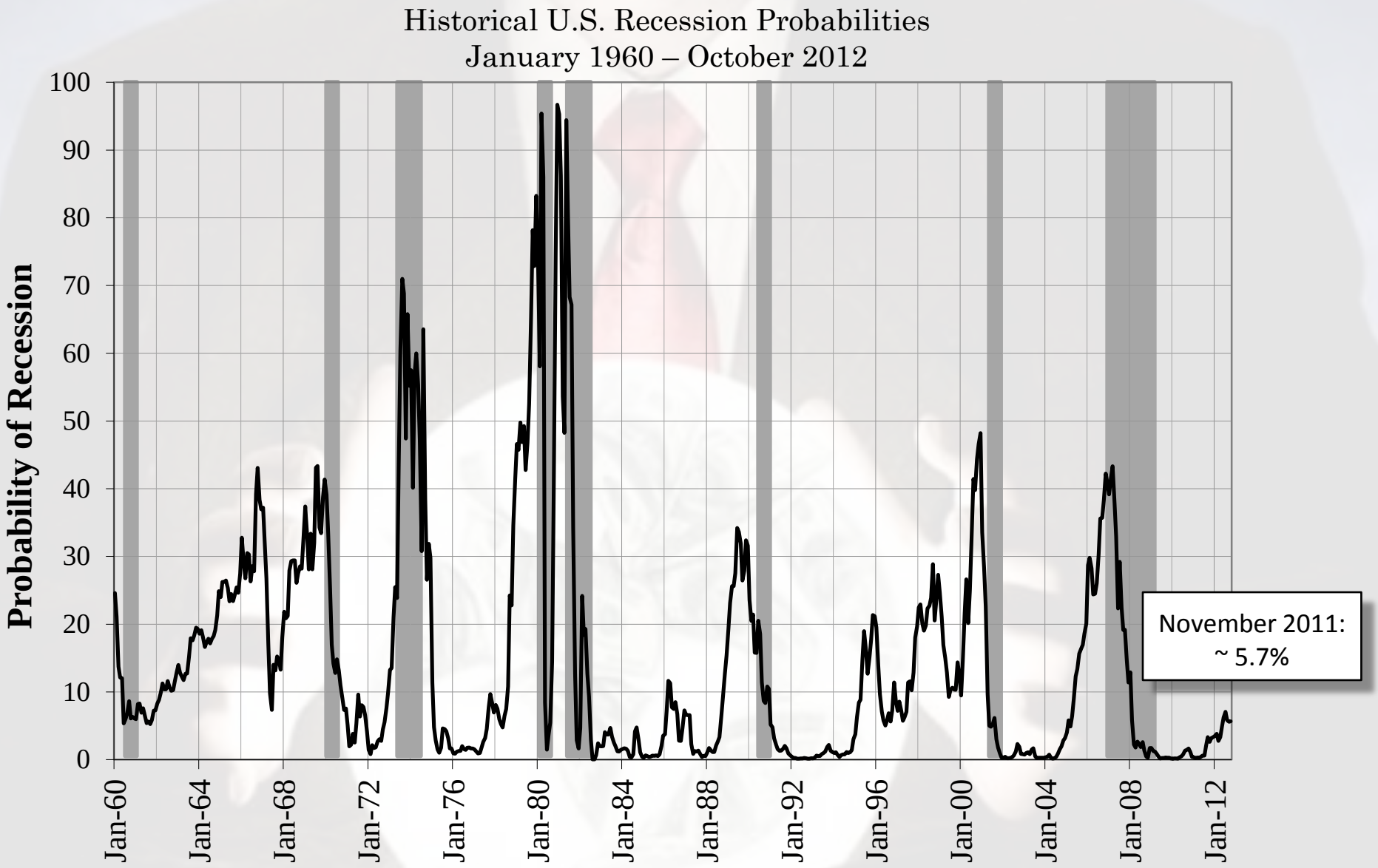
Source: Bureau of Economic Analysis data. Smoothed series generated using a Hodrick-Prescott filter.

Forecasting probabilities of recessions



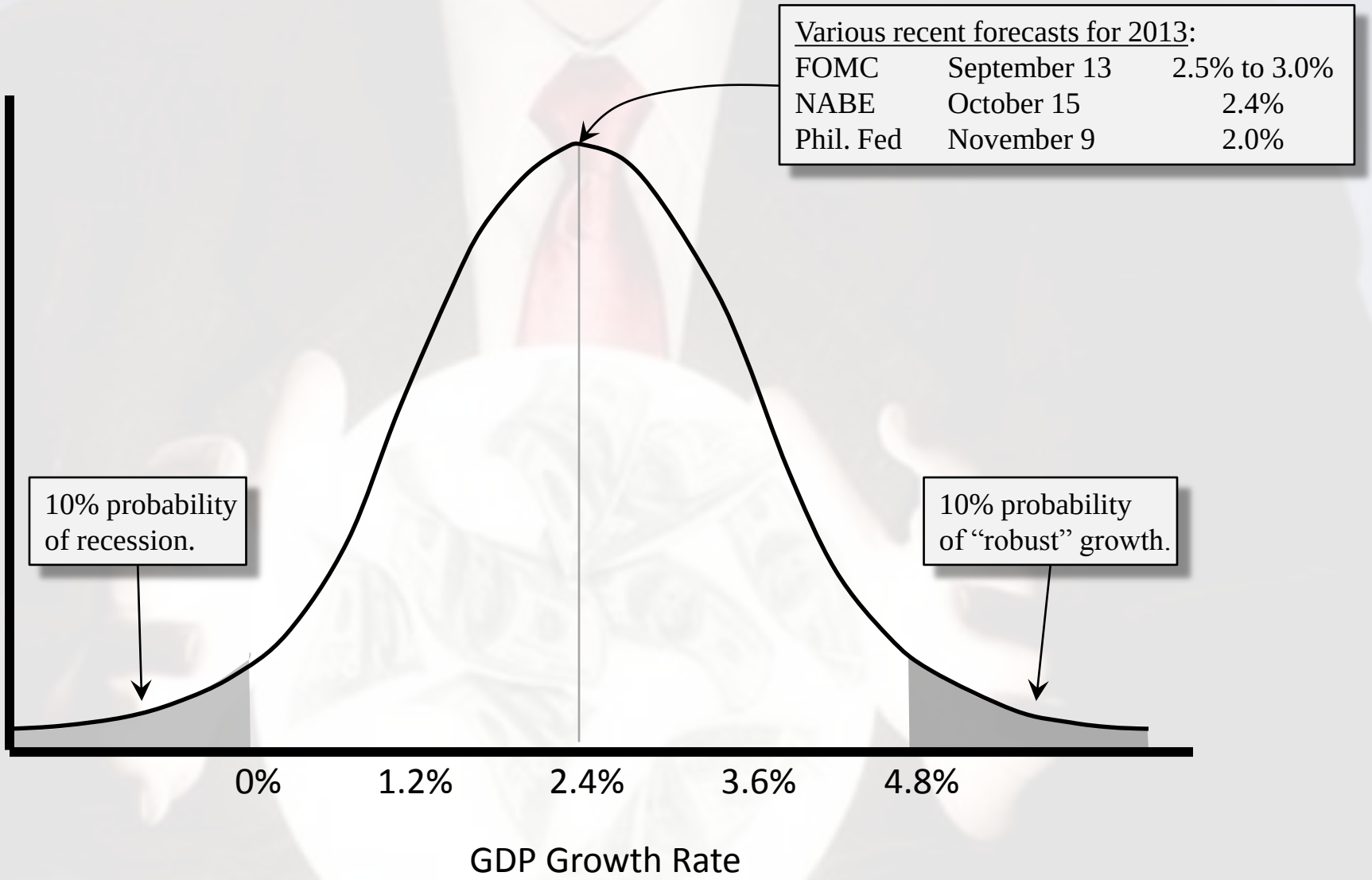
Source: Jeremy Piger, University of Oregon, http://pages.uoregon.edu/jpiger/us_recession_probs.htm

Forecasting probabilities of recessions



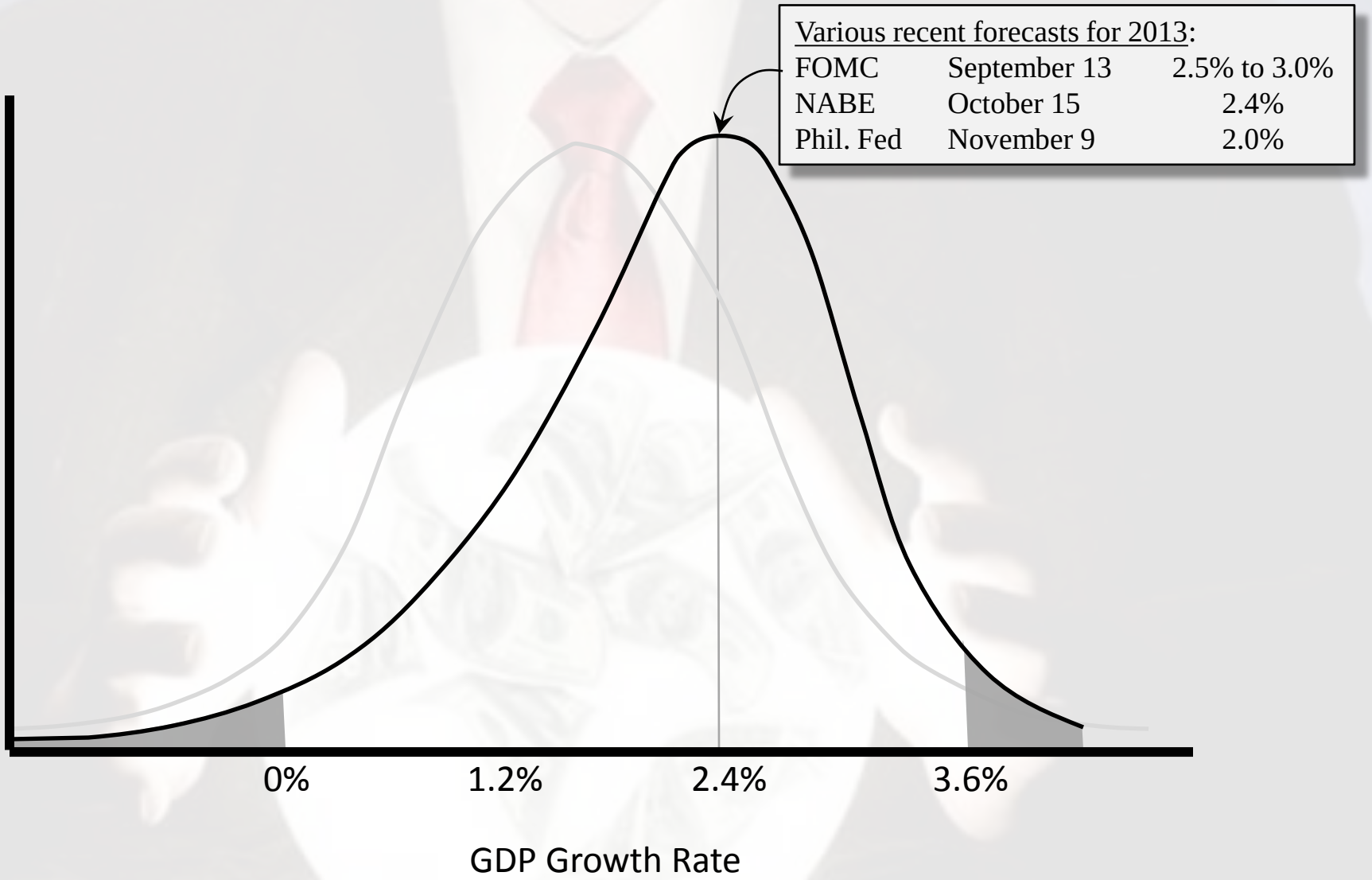
Source: Kevin Christ, Rose-Hulman Institute of Technology, based on Estrella and Trubin, "The Yield Curve as a Leading Indicator: Some Practical Issues", NYFed Current Issues (2006), http://www.newyorkfed.org/research/current_issues/ci12-5.html

Going out on a (fairly sturdy) limb…



Going out on a (fairly sturdy) limb…

Downside risks are more pronounced than are upside opportunities



Downside risks are more pronounced than are upside opportunities

1. **Europe:** There are some signs that the required political will is emerging and that some "structural adjustment" is underway.

2. **China:** The greatest threat to the U.S. economy of a slowdown in China is via rising geopolitical tension.

3. **Failure to choose the right line down the fiscal slope:** … especially when the housing and labor markets finally seem to be showing signs of recovery.