WHAT WILL THE RE ELECTION OF PRESIDENT OBAMA MEAN FOR FINANCIAL MARKETS?

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11/07/2012

With Barack Obama's victory this week, one of the sources of market uncertainty—the outcome of the election—no longer hovers like a gray cloud over the investment landscape. However, three other sources of uncertainty still remain, each of which is likely to have a significant impact on the direction of financial markets: whether the president and a lame-duck Congress can resolve or postpone the [glossary href="The "fiscal cliff""]"fiscal cliff"[/glossary] before Congress is scheduled to adjourn on December 14; whether Washington lawmakers can raise the federal debt ceiling in early 2013 without triggering a financial crisis; and whether President Obama can do in 2013 what he failed to do during his first term, that is successfully negotiate a long-term budget agreement with Congress that combines reductions in the growth of entitlement spending with increases in federal tax revenue to reduce the federal deficit over the next decade. A large source of uncertainty for the past months has been that investors do not know what federal tax rates will be in 2013. In the coming weeks, that, too, will come into focus. Under current law, all the Bush tax cuts on earned and investment income are set to expire at the end of this year. In his 2012 budget to Congress, President Obama proposed extending existing tax rates for household income up to $250,000 and allowing rates to increase for families making more than $250,000. Unless the president and Congress reach a compromise or agree to delay increases in existing rates until a comprehensive budget agreement can be negotiated in 2013, the top tax rate on ordinary income would revert back to 39.6%. Because President Obama increased Medicare payroll taxes by .9% and passed a tax of 3.8% on investment income to finance health insurance reform, families with adjusted gross income above $250,000 are scheduled to face a top rate of 40.5% on wages, 43.4% on taxable interest and dividend income and 23.8% on capital gains.[1] During the last days of the campaign, the White House indicated that it would veto any "fiscal cliff" resolution that failed to raise income tax rates for the wealthiest Americans.[2] This declaration makes it doubtful whether a compromise can be reached with the Republican-controlled House, many of whose members have, in effect, said, "Read my lips," by signing pledges not to raise taxes. Should a stalemate develop that prevents a resolution, taxes would go up for all Americans: $800 billion over 10 years for the top two income brackets; $3.2 trillion over 10 years for all other tax payers. In addition to these tax increases, $1.2 trillion in negotiated spending cuts and another $1.2 trillion in automatic "sequestration" cuts are also scheduled to take effect beginning in January of 2013.[3] The Congressional Budget Office (CBO) estimates that the combination of policies under current law will reduce the federal budget deficit by $607 billion, or 4% of gross domestic product (GDP), between fiscal years 2012 and 2013. If not amended or renegotiated, $6.4 trillion in tax hikes and spending cuts would result in roughly a $600 billion drag on the economy each and every year for the next decade. At a time when the Federal Reserve has used extraordinary means to see that deflation does not take hold in the United States, a fiscal policy this austere would likely reduce after-tax income, increase unemployment and reduce aggregate demand. Not only would such a policy risk tipping the U.S. into recession in 2013, it would also increase the country's odds of entering a debt-driven, deflationary spiral. Thus, if rates rise and spending is cut because no action is taken in the lame-duck session, we would expect the new Congress, fueled by public outrage in 2013, to reach a new negotiated agreement with the president that restores cuts in defense and domestic spending and that reverses some of the tax increases affecting lower- and middle-income Americans. However, higher tax rates on the highest-income Americans could well remain one of the legacies of a second Obama term. We expect volatility in equity markets to increase between now and the end of the year. Since a failure to resolve the "fiscal cliff" could tip the economy into a politically induced recession for the first half of 2013, I expect the market to trend lower between now and the end of the year, discounting the possibility that a deal will fail to materialize. I believe Wall Street underestimates how difficult it will be for an agreement to be reached. I believe the president will couch the debate in terms of his wanting to maintain existing rates for 98% of American taxpayers and, in effect, force the Republicans in the House to part their lips and raise taxes on the top 2% of taxpayers. Unless Congress is willing to pass another increase in the debt ceiling that takes that issue off the table for President Obama's second term, I do not believe the White House will negotiate on this issue. Fasten your seat belts for another round of fiscal chicken. *To understand what impact higher dividend tax rates could have on the U.S. equity market, please see recent research from WisdomTree.* [1]This description of the new marginal tax rates set to take effect in 2013 does not account for the elimination of itemized deductions, which could make the actual rates that high income earners pay even higher (source: Congressional Budget Office).[2]"Officials: Obama Ready to Veto a Bill Blocking 'Fiscal Cliff' Without Tax Hike For Rich," *The Washington Post*, October 17, 2012. [3]Bob Woodward, "The Price of Politics," Simon & Shuster, 2012, p. 366.

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