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THE DIP AT END OF THE ROAD

Well, the US elections are over and President Obama has been re-elected. But all of the economic uncertainty has not gone away.

It really wasn't the election after all. Markets are still bound by a knot of unanswered questions.

And, alas, as we look again at what will happen if the US economy goes over that fiscal cliff, let me break it down once more. If all the tax increases and spending cuts get enacted, the United States will see a hit to GDP of roughly 4.5%. Right now the United States is growing at a 2% real rate. So if Washington policymakers do nothing, the US economy is going to land in recession.

All the components are there. There is a broad-based tax increase scheduled to kick in; this alone will subtract 1% from GDP. There is a payroll tax cut that expires, jobless benefits that are going to be reduced and a sequestration that will force spending cuts because last year Congress did not agree to raise the debt ceiling. And, all of these increases and cuts will kick in at the same time that the Bush tax cuts, which we have been living with for the past eight years, expire.

So, are we going to go off the cliff?

No. Because nobody, be they Republican or Democrat, wants a recession.

Because if the US economy goes into recession, we will see unemployment and welfare benefits skyrocket and tax receipts collapse. At the same time, the interest on the debt is going to compound, resulting in even higher bills over the next five years for the US government. The debt will make it even worse.

So, it is in everyone's best interest to NOT let this train go over the cliff. I think, however, policymakers will let the economy hit a speed bump. My best guess is that the Social Security and payroll taxes will stay in place and that the Affordable Care Act will probably be maintained. We think Republicans are willing to make a deal to raise taxes somewhat. Anyone in the highest brackets probably will experience a tax jump of as much as 40%. Why is that? It would show a glimmer of bipartisanship. Both the White House and the Republican rank and file feel that a tax increase on high-income earners would not cause great harm and would paint a picture of more fairness. The Republicans know they have been tagged with being too "pro-rich." So they can afford to agree to a tax increase for people in the higher brackets.

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In making these compromises, the government will not solve the underlying issues. Taxing the rich at 100% of marginal income doesn't get you enough money to solve America's problems. The government hasn't told the people that the real problem lies with mounting expenses tied to both health care and Social Security.

And my bet is that lawmakers are going to string out an agreement till the eleventh hour. They love the publicity. They want us to be all riled up. But I think there is a deal in the works. We may be at a New Year's Eve party and still not have a definitive answer. But a deal is in the works to spare this economy the wreckage of another Lehman-type recession, and early January will bring the details. However, don't expect a grand bargain to fix the longer-term problems.

I think US GDP will take a hit of about 1% or less, but with housing, automobile manufacturing and exports all doing better, we have enough growth elements to keep the business cycle going forward well into 2013. So I would guess the United States economy will see a slow first quarter but not a recession.

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