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MANAGEMENT
Planning for Your Dreams

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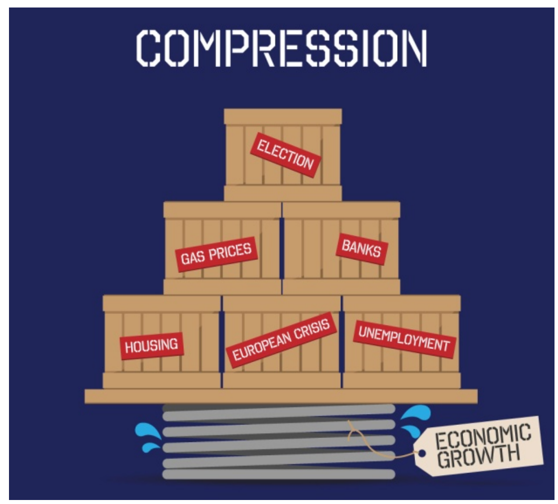
PENCE PERSPECTIVES - *December 2012*

Bottom Line Up Front:

In our September Newsletter, I spelled out the fundamentals of the phenomenon that we call COMPRESSION (see chart one) and how external events and uncertainty were holding back what was a moderate strengthening economy. We had an election: Obama won, Romney lost. The Democrats have the White House and the Senate, the Republicans have the House. After months of hyperbole and billions of dollars, at first glance not much changed. The most important thing about the election is that it is over. The balance of power in 2013 is about the same as in 2011 and 2012. Here is the difference. Before the election, the economy was going to be a big driver of the politics. After the election, politics is going to be a big driver of the economy. The so-called "Fiscal Cliff" is a real issue and we are at one of the few times in history where policy really does make a difference in both the short and long run. Thus, I am devoting almost this entire letter to the Fiscal Cliff. Breathe…. don't panic, taxes are going to go up, we have seen this before and together we will get through it.

Chart One



The way we see it:

No matter what happens, no amount of tax increases or spending cuts will solve our problems if we don't have an economy that eventually grows at about 4%. A 4% growth rate helps solve a lot of problems. On chart two, I have outlined what we really mean by the Fiscal Cliff. It is a significant increase in taxes simultaneous with significant cuts in spending which together pull about 3.5% out of an economy growing at only 2.0% for the last three quarters. The average consensus estimate before the Fiscal Cliff became an issue, was that US GDP would grow about 2-3% in 2013. An estimated 3.5% drag can result in negative growth rates of between -0.5% to -1.5%; thus, taking the fragile economy into a recession. That is it. From an economist view point this is a math problem.

We see *three reasonable scenarios*:

- *One*, we get a "**Grand Bargain**" now which helps us really attack the long term issue of our deficit.
- *Two*, we go over the cliff. Then we get some sort of a "**Panic Fix**" similar to TARP-type legislation that took place in the 2008 crisis because political dysfunction has generated a massive "GROW UP" from all sides of the electorate.
- *Three*, we get a "**Small Fix**" now with a **bigger fix** later, perhaps in stages.

I have placed the Fiscal Cliff and current Compression (see Chart Three) charts side by side as they are related. The spring underneath the crates in the current Compression chart is our economy with great potential growing at only about 2% (so far in 2012). The spring is weighted down by uncertainty about many issues, one of which is the Fiscal Cliff, outlined in chart two. It explains the projected 3.5% contraction in the economy that would occur if we went off the Cliff and did nothing.

Chart Two

Fiscal Cliff **2013 Fiscal Headwinds (in $ billions)**		
Expiration of Bush tax cuts for middle income earners		$205
Expiration of Bush tax cuts for high earners		$50
Payroll tax cut for workers		$112
Debt ceiling annual spending sequester for defense		$55
Debt ceiling annual spending sequester for non-defense		$55
Alternative minimum tax annual "patch"		$38
Medicare tax of 3.8% on investment income From 2009 Obama health care plan		$21
	Total:	**$536**
Total as % of estimated 2013 GDP		**-3.5%**
Source: Congressional Budget Office, Office of Management and Budget, LPL Financial Research 02/06/12		

Chart Three

We know that taxes are increasing and spending is decreasing. The only question is when and to what magnitude. Remember, uncertainty is a big weight on the economy. Relieve the uncertainty and more growth can occur. Our analysis of the *three* likely options is:

- *Option one*; the **Grand Bargain** now, would be the best scenario, be positive for the economy and the markets. It is also the least likely.
- *Option two*; we **go over the Cliff** and then try a panic fix. It would be the worst scenario. It could create significant market volatility, possibly multi-hundred point swings and a potential down grade of US Debt. This is possible, but note, if we go over the Cliff, we don't stay there, it is more like a bungee jump or a bounce. Regardless, it will be traumatic and introduce a lot of unnecessary volatility and uncertainty. It will also produce significant opportunity for those that take advantage of the volatility. We see this as a possible outcome, and considerably more likely than option one. Because this is the worst case, we are watching it most closely.
- *Option three;* we get a **short term fix** that is a down payment on a longer term, and more thoughtful solution. This is what we see as most likely scenario. It will create volatility in the market but the upside will be greater than the downside. Ideally, it is a case where the short term effects are about a one percent reduction in economic growth once you balance spending cuts and tax increases. It then gives the economy a few months to adjust, while Congress implements a larger, more universal plan. It produces a short term slowing of the rate of growth but not a recession.

For our portfolios, one of the most important components to whatever plan is chosen will be maintaining the long-term capital gains tax and the tax on dividends and interest at the same rate, and at a rate below that of ordinary income taxes.

We see this as the most important component to the portfolios we manage as it gives companies an incentive to pay dividends and maintain prudent balance sheets. So far, most of the discussion we have had with congressional leaders and news we have followed have indicated, that while the tax rate might go up, the levels will still be the same and less than that of ordinary income.

The Big Knowable Themes:

Taxes will rise, spending will fall. There will still be more heat than light generated by Congress but the US economy will continue to grow slowly in spite of the politicians. The removal of uncertainty about the Fiscal Cliff will overcome part of the contraction generated by its components. This will lead to a continuation of the short term pattern of upward sloping market volatility that we have seen for the past two years. There is more up ten, down seven, to come. Remember, that for most of the American consumers, in the short and intermediate term, the actions by Congress have very little to do with how much toilet paper consumers buy.

Actions:

For our clients with *Strategic Asset Management* (SAM) accounts where we manage with full discretion, depending on your individual situation and account, we are still clearly focused on cash flow, dividend paying stocks, high yield bonds and managing risk.

Cash positions may increase well above the normal 2% levels as we seek to balance **two issues**:

- **One**, seeking to limit risk in the event of a market sell-off from either going over the Fiscal Cliff or having a set of unclear or protracted solutions.
- **Two**, taking advantage of the volatility generated by the political uncertainty to buy solid companies we like when their stock price is at what we feel to be of good value.

For our clients who hold brokerage accounts, **if you are interested in similar fee-based strategy please contact your advisor.**

If you are not yet a client**, and are interested in learning more about our services, please contact Lanae King (949) 660-8777 ext 100 or** lanae.king@lpl.com **to schedule an appointment.**

I strongly encourage you to attend our annual client luncheon next year on **Saturday, April 27th, 2013**. It is at this annual event where I lay out our key thoughts for the entire year and those clients and potential clients who attend always find it rewarding and informative. If you would like to receive an invitation please email abigale.jasinsky@lpl.com.

As Pence Wealth Management embraces the digital age, we encourage you to like us on Facebook, follow us on Twitter and check our daily blog on our website www.PenceWealthManagement.com/blog.

For our clients, friends and prospective clients we wish to remind you that, once again, we have been recognized by Barron's Magazine as one of the top Financial Advisors in the Nation (Barron's criteria: based on assets under management, revenues generated by the advisor and quality of their practices).

We are accepting new clients, and the greatest compliment or gratitude that you can show us is the referral of a friend or family member. If you would like a hard copy version of this newsletter to pass on, please contact Anne Godfrey anne.godfrey@lpl.com or (949) 660-8777 ext 116.

We appreciate your trust and the opportunity to be of service.

All the best, ❖

E. Dryden Pence III, CPM®, AIF®

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