***Forza Investment Advisory Weekly Newsletter***

***From the Desk of Bob Centrella, CFA: October 15, 2012***

***"So Just What is the Fiscal Cliff?"***

Sorry I am quite late with my "morning" update but I was travelling from PA today so I was not able to produce my usual newsletter. I've attached the weekly data sheet which does contain a summary of key financial data from last week. Since I am late and short on time, I will dispense with my usual Monday morning banter and get right to today's belated topic - The dreaded Fiscal Cliff.

With all this talk of the "Fiscal Cliff" and the ramifications, I thought I'd send out a compilation of a few different articles I've read that gives a brief but concise description of exactly what happens on January 1st, 2013 when the tax breaks expire and the spending cuts go into effect. As I have mentioned before in prior newsletters, this is an extremely important issue and I can't believe it wasn't addressed in the first presidential debate. Hopefully, we will hear a lot about it tomorrow night. Over the next week or so I will send a few more articles that give greater detail and try to explain how the economy and each of us might be affected. I think the info below is a good first step of outlining the looming problem.

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**FISCAL CLIFF DEFINED**

"Fiscal cliff" is the popular shorthand term used to describe the conundrum that the U.S. government will face at the end of 2012, when the terms of the Budget Control Act of 2011 are scheduled to go into effect. It consists of the simultaneous expiration of numerous tax breaks coupled with mandated federal spending cuts.

If we "fall off the Fiscal Cliff" - that is if no action is taken on these expiring tax breaks - taxes will increase by an average of about $3,500 per year per household. That's equivalent to the average family taking on a new bill of $300 per month just for tax increases. According to a study by the Tax Policy Center, the Fiscal Cliff consists of six components that expire December 31, 2012:

First are the Bush tax cuts from 2001 and 2003 that were extended in 2010.

Second we have the temporary tax cuts that were part of the ARRA, the American Recovery and Reinvestment Act of 2009.

Third, Congress has not acted on several temporary tax breaks that are usually extended.   
  
Fourth, the payroll tax cut is set to expire resulting in a 2% tax increase for workers.

Fifth, the new taxes in the ACA, the Affordable Care Act, will begin in 2013.   
  
Lastly, the AMT patch expired in 2011, so millions of taxpayers may be subject to the AMT or alternative minimum tax.

At the same time, the spending cuts agreed upon as part of the debt ceiling deal of 2011 will begin to go into effect. According to *Barron's*, over 1,000 government programs - including the defense budget and Medicare are in line for "deep, automatic cuts."

In dealing with the fiscal cliff, U.S. lawmakers have a choice among three options, none of which are particularly attractive:

* They can let the current policy scheduled for the beginning of 2013 - which features a number of tax increases and spending cuts that are expected to weigh heavily on growth and possibly drive the economy back into a recession - go into effect. The plus side: the deficit, as a percentage of GDP, would be cut in half.
* They can cancel some or all of the scheduled tax increases and spending cuts, which would add to the deficit and increase the odds that the United States could face a crisis similar to that which is occurring in Europe. The flip side of this, of course, is that the United States' debt will continue to grow.
* They could take a middle course, opting for an approach that would address the budget issues to a limited extent, but that would have a more modest impact on growth.

**Can a Compromise be Reached?**

The oncoming fiscal cliff is a concern for investors since the highly partisan nature of the current political environment could make a compromise difficult to reach. This problem isn't new, after all: lawmakers have had three years to address this issue, but Congress - mired in political gridlock - has largely put off the search for a solution rather than seeking to solve the problem directly. Republicans want to cut spending and avoid raising taxes, while Democrats are looking for a combination of spending cuts and tax increases. Although both parties want to avoid the fiscal cliff, compromise is seen as being difficult to achieve - particularly in an election year. The most likely result, in any event, is that the problem will linger at least until after the election, and there's a strong possibility that Congress won't act until the eleventh hour. Another potential obstacle is that the next Congress won't be sworn in until January 3.

The most likely result is another set of stop-gap measures that would delay a more permanent policy change until 2013 or later. The election will almost certainly have an impact on the direction of future policy, particularly if one party earns a decisive victory. Nevertheless, the non-partisan Congressional Budget Office (CBO) estimates that if Congress takes the middle ground - extending the Bush-era tax cuts but cancelling the automatic spending cuts - the result, in the short term, would be modest growth but no major economic hit.

**\*\*Possible Effects of the Fiscal Cliff**

If the current laws slated for 2013 go into effect, the impact on the economy could be dramatic. While the combination of higher taxes and spending cuts would reduce the deficit by an estimated $560 billion, the CBO estimates that the policies set to go into effect would cut gross domestic product (GDP) by *four* percentage points in 2013, sending the economy into a recession (i.e., negative growth). At the same time, it predicts unemployment would rise by almost a full percentage point, with a loss of about two million jobs. A Wall St. Journal article from May 16, 2012 estimates the following impact in dollar terms: "In all, according to an analysis by J.P. Morgan economist Michael Feroli, $280 billion would be pulled out of the economy by the sunsetting of the Bush tax cuts; $125 million from the expiration of the Obama payroll-tax holiday; $40 million from the expiration of emergency unemployment benefits; and $98 billion from Budget Control Act spending cuts. In all, the tax increases and spending cuts make up about 3.5% of GDP, with the Bush tax cuts making up about half of that, according to the J.P. Morgan report." Amid an already-fragile recovery and elevated unemployment, the economy is not in a position to avoid this type of shock.

The cost of indecision is likely to have an effect on the economy before 2013 even begins. The CBO anticipates that a lack of resolution will cause households and businesses to begin changing their spending in anticipation of the changes, possible reducing GDP by a full half-percent in the second half of 2012.

Some of the most immediate effects on investors will be affected in the following areas - the long term capital gains rate will increase, the dividend tax rate will increase, Muni bond investors may be subject to the AMT and the estate tax will increase with substantially lower limitations. The long term capital gains rate will increase from 15 percent to a maximum of 25 percent for high income investors. The dividend tax rate will go from 15 percent to a maximum of 39.6 percent.   
  
Municipal bond investors who are not subject to the AMT could become eligible and see a decline in their after tax income. If you have a sizable estate, 2012 could be one of the best years to do some gifting as the estate tax rates will increase and the exemptions will be lowered.

Having said all this, it's important to keep in mind that while the term "cliff" indicates an immediate disaster at the beginning of 2013, the impact of the changes - while destructive over a full year - will be gradual at first. What's more, Congress can act to change laws retroactively after the deadline. As a result, the fiscal cliff won't necessarily be an impediment to growth even if Congress doesn't address the issue until after 2013 has already begun.

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