

**BEACON POINTE**

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**BEACON'S POINT: STATE OF THE POST-ELECTION UNION**

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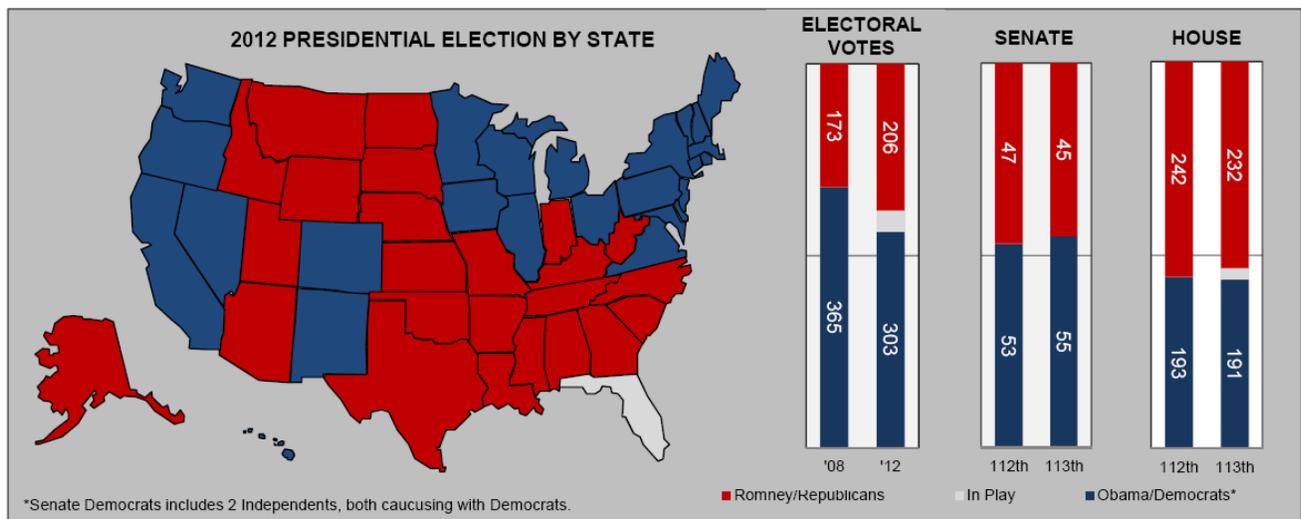


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## State of the Post-Election Union

With the Fiscal Cliff on everyone's mind, we are reminded of an Oscar winner from two decades ago. The 1991 film, "Thelma & Louise", is the story of two women's road trip that goes terribly wrong. Circumstance and some very poor choices made along the way turn the vacationers into fugitives. The most memorable scene comes at the end of the film, when the police finally catch up with the women a hundred yards from the edge of the Grand Canyon. Faced with an impossible decision but unable to undo their prior actions, Thelma and Louise drive the car off the cliff.

Today the U.S. faces equally difficult decisions with time running out. In the following paragraphs, we will discuss the state of the post-election union and consider the tremendous challenges of dealing with the fiscal cliff issues. Beacon Pointe's message to clients is that our manager selection strategy takes into account the risks created by an uncertain macroeconomic and political backdrop, such as the one we face today. The reason we favor certain investment managers and the reason these managers have been conservatively positioned in recent quarters is the awareness of the dangers of cliffs -- fiscal and other kinds -- in our near and intermediate future. Our primary objective has been to keep our clients' portfolios in a position of relative safety and prepare them for potential negative scenarios.



Source: Northern Trust, CNN

After the votes were counted and the Electoral College results tabulated in the late hours of November 6<sup>th</sup>, the new government chosen to lead the country for the next 2-4 years looks very much like the old government. President Obama was given a second term in office while Congress remains split between a Democrat-controlled Senate and a Republican-controlled House of Representatives. It would be reasonable to expect Ben Bernanke's policies of quantitative easing and low interest rates to remain in place. In addition, it now appears certain that the Affordable Care Act (aka Obamacare) will result in higher taxes for compensation and investment income starting next year. The most significant sources of uncertainty that remain are the looming fiscal cliff and the debt ceiling. Because of the still-divided government, the two opposing sides have no choice but to work together on the policies and solutions needed to address these massive fiscal challenges.

The next session of Congress begins on Monday, November 12<sup>th</sup>. Priority #1 will be addressing the multiple components of the fiscal cliff, including the Bush-era tax cuts, payroll tax cuts, emergency unemployment insurance benefits, depreciation incentives, the Alternative Minimum Tax, and various mandated spending cuts. If not addressed, this tightening could represent a roughly \$600 billion hit to GDP and almost certainly push the economy into a recession. While neither political party wants to be seen as responsible for a recession, reaching consensus will be a hard-fought and drawn-out battle over the last six weeks of 2012.

In addition, the debt ceiling -- which currently stands at \$16.4 trillion -- will likely be reached in the January-March 2013 timeframe. Congress was last faced with a decision to raise the limit on federal borrowing in August 2011, when a political stalemate and a contentious last minute resolution rattled global markets, led to the unprecedented credit downgrade, and pushed some assets briefly into bear market territory. Whether or not history repeats itself in 2013 will depend on the elected officials' political will for compromise.

Beyond the short-term fiscal cliff and debt ceiling issues lurk the longer-term challenges of restoring the U.S.' fiscal health through debt reduction, entitlement reform, and tax reform. The election outcome did not provide a clear signal about how these challenges would be tackled. Little progress was made on the fiscal front over the past four years, which does not bode well for the next term. However, according to Eaton Vance's Washington analyst:

*Will the next four years be different than the last four? History suggests there is a chance. Presidents spend their first terms worried about getting re-elected. They spend their second terms worrying about their legacy. In his second term, Ronald Reagan worked with a Democratic Congress to rewrite the tax code (the last time this has been done). Bill Clinton alienated members of his party to work with Congressional Republicans to craft welfare reform. The "legacy" issue for a second Obama term is the federal budget deficit. ...The President [has] said that he intends to tackle the deficit early in his second term. Will he in fact do so, and will the Republicans join him in that effort or thwart it?*

*Source: Andrew H. Friedman, Eaton Vance, "The Washington Update"*

The U.S. finds itself in a precarious position. We have reached the proverbial end of the road with just 100 yards to go to the edge of the cliff. It is very hard to change course at this point. So, if forward is the only way to go, would it be a rush to the end or a slam on the breaks? And if a fall is inevitable, can it be softened? A parachute certainly helps -- the greater control allows those who jump to guide themselves to safety, land on their feet, and often end up on higher ground than those who free-fall to the bottom. From that advantageous position, the well-prepared can more easily climb up the other side and continue on their way to the original destination.

While the fiscal cliff, debt ceiling, and budget deficit debates could result in a positive outcome (avoiding a fall), we need to take into account the possibility that the opposite occurs. Beacon Pointe's portfolio recommendations are made with this risk in mind. It is better to have a parachute on your back and not need it than to need one and not have it. After all, an unnecessary parachute would only slightly slow down your progress, but an absent one could completely take you off course.

## **BEACON POINTE RESEARCH**

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Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.