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Cliffhanger

Democrats have been cheering the results of the just concluded US elections, which have given incumbent US President Barack Obama another 4 years to continue his mandate. However, it is not just the Republicans who have reason to keep their heads bowed. For investors holding US stocks, the past few weeks have been harrowing as well. After hitting its high for the year less than 2 months ago, the Dow Jones is now down more than 1,000 points since then. This brought it close to erasing all its gains for the year. Likewise, the S&P 500 has fallen more than 100 points over the same time period

Fiscal cliff - Behind the sell-off

Republicans would probably point to Obama's victory as the reason behind the US stock market's sudden bearishness. However, if there is anything that an Obama win would have assured, it is a showdown in the Republican-dominated Congress over the "fiscal cliff." Remembering the politicking that caused last year's debt ceiling debacle, uncertainty over the resolution of this issue caused many investors to take risk off the table and sell their stocks. If Congress is unable to hammer out a mutually acceptable budget deal, a mutually unpalatable combination of tax increases and spending cuts will automatically be implemented upon the expiration of former President George W. Bush's tax cuts on December 31, 2012. Failure to address this cliff may cause the US economy to contract by about 0.5% in 2013, bringing it into a recession. This could lead to the loss of 2 million jobs, causing the unemployment rate to rise to 9%. It is precisely the fear of this happening that has led to the sell-off in the past week. With the global economy slowing down, it cannot afford any further drags to its growth, lest it finally grind to a halt.

Taxmageddon

If Congress fails to act, included in the whole slew of tax increases is a higher capital gains and dividend income tax rate. From the current 15%, capital gains tax will rise to 20%. As for dividends, the top tax rate will more than double from the current 15% to 43%. While the impact may not be significant for traders who churn constantly, imagine the situation of an investor who had been holding Apple (NSDQ: AAPL) shares since $100. If he were to sell his 5-bagger AAPL shares at current prices, he would lose more than 20% of his return to the increase in capital gains tax. To head this off, many long term investors have decided to just sell their stocks, especially those that have more than doubled since the initial purchase.

Uncertainty Abounds

If there is one thing that every investor hates, it is uncertainty. Not only does the higher volatility make it more difficult to invest, but it also causes many market participants to stay in the sidelines. In addition to doubts over the resolution of the fiscal cliff, there is also the lack of a clear resolution of the European crisis. With the spotlight now on Greece and Spain, the fluidity of the Eurozone crisis and fragility of the Euro itself have contributed to the jitters now rocking global equity markets. Until a final solution has been crafted, we expect this high level of uncertainty to remain as an overhang.

At Equilibrium

Although there is no clear catalyst to push the market up at this point, central bankers have successfully lifted the stock market. Both Fed Chairman Ben Bernanke and ECB President Mario Draghi have stepped up their rhetoric and brought out their respective bazookas to stave off the possibility of a recession and a stock market rout (see *The Great Global Monetary Easing*, 22 October 2012). With uncertainty keeping stock markets from rising and additional liquidity keeping them from falling, equities have remained in an equilibrium state. With stock markets at a cliffhanger, any catalyst or risk that materializes could easily push stock prices higher or be the final push sending them down into the abyss.

A Golden Opportunity

While the possibility of the US going over the fiscal cliff has made investment a very risky business, JP Morgan CEO Jamie Dimon believes that this is an opportunity for American legislators to spur the country forward. According to Dimon, lawmakers should strike a deal to avoid seeing extreme tax hikes and hefty spending cuts take effect at the same time. He believes that the Simpson-Bowles proposal provides the clearest path away from the fiscal cliff. If lawmakers implement that plan, he says that the economy would boom, especially when one considers that economic fundamentals are showing signs of improvement. Just as in Europe, a clear roadmap out of this crisis will push stock markets higher for years to come. Dimon said that while Europe has the will, it does not have a clear cut solution to its crisis. On the other hand, the US has the solution but lacks the will to see it through.

Race to New Highs Stalled Temporarily

In spite of concerns over the fiscal cliff and the European crisis, the Philippines has managed to stay close to its all-time high of 5,488.92. Currently at 5,439, the PSEi is still up 24% YTD. However, if world stock markets keep dropping because of the US fiscal cliff, it would make global stocks cheaper relative to local stocks. That being the case, the Philippines would be sticking out like a sore thumb if it continues on its upward trajectory. If not for the US market sell-off, the Philippine market would still be making new highs. Instead, we are now experiencing a correction, temporarily stalling its rise.

The Sin Tax

Unlike the US economy, which is pretty much at the precipice, the Philippines is nowhere close to experiencing a fiscal cliff. In a previous article (see *5-peat in the Philippine Stock Market*, 29 October 2012), we mentioned that "investors typically reward economies and countries that take concrete steps to improve their finances." With our legislators currently deliberating a new sin tax, our fiscal position will only gain strength. The Drilon version of the sin tax bill has been endorsed by the Makati Business Club, Philippine Chamber of Commerce and Industry (PCCI) and even IMF Chief Christine Lagarde herself. Whereas the US should tread carefully on additional taxes because they have a very weak economy, a sin tax for the Philippines would actually provide a boost for the country. While US legislators are bickering, President Aquino has endorsed the sin tax bill as urgent, showing that our government, economic managers and enlightened lawmakers are more responsible than their Western counterparts. Thus, we reiterate our view that investors stay long Philippine stocks and view these dips as opportunities to buy issues with good growth prospects and sustainable business models.

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