"The United States invariably does the right thing, after having exhausted every other alternative." – Winston Churchill.

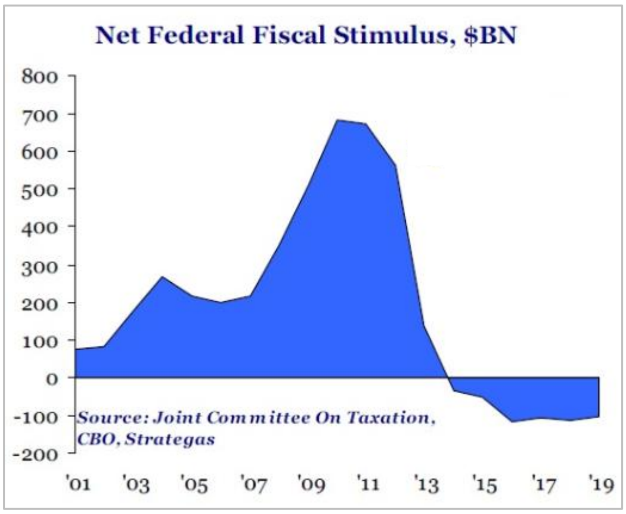
OK, perhaps a bit harsh but certainly the markets are waiting with baited breath to see if Congress can sort out the dreaded "Fiscal Cliff" before it is too late.

So, **what** does "Fiscal Cliff" actually mean, **how** has it come about and **why** is it so important?

When any government **cuts spending** on goods and services, less money enters the economy and growth prospects fall. Likewise, when people **pay more tax**, they have less to spend and therefore less money enters the economy and growth prospects fall.

The combination of both **spending cuts** and **tax increases** at exactly the same time is a double whammy that is likely to push any economy over a growth "cliff" and into recession. Voila, the term "Fiscal Cliff" is born.

As of midnight, December 31, 2012, the US Economy is facing just this possibility. The laws set to change include the end of temporary payroll tax cuts (resulting in a 2% tax increase for workers), the end of some tax breaks for businesses, cessation of the tax cuts created from 2001-2003 and the beginning of taxes related to President Obama's health care law. At the same time, spending cuts will be adopted and it is likely that over 1,000 government programs - including major, automatic cuts to the defense budget and Medicare.



Government Stimulus of the US economy will be negative in 2013.

So now to the "**why**" – Everyone knows that the US has been borrowing and borrowing, living on cheap credit from China (China owns 26% of all US Bonds and incidentally are incentivised to lend to their biggest customer (see it as a "hire purchase" arrangement).

As a result of this growing line of credit, you may remember that last August (after nearly seven months of debate), US Congress finally agreed to an increase in the US national debt ceiling to $16.39 trillion in exchange for immediate cuts to spending of over $900 billion over 10 years and an additional $1.2 trillion to be trimmed over nine years. This led to a downgrade of the US's top quality AAA rating by agency S&P, a rating that they had held for over 70 years. The message was clear – "You are borrowing too much and not doing enough to pay it off sooner". It's a bit like a homeowner re-mortgaging their house to pay for a new kitchen and bathroom and then telling the bank after the event that they can't have any interest payments for 12 months.

Extending the homeowner analogy a little further, it's the 12-month lag that we are now worried about, because the time has come to start paying off that mortgage. The only way to do this is to reduce spending and to save more. Not such a bad discipline, you might say, but what the US economy really needs at the moment is people spending money (in the form of Government spending), not saving it (in the form of higher taxes). All very messy.

So what is the solution? Well – there are really 3 options and they are all fairly grim:

1. They can implement the proposed policies scheduled for the beginning of 2013 – (a number of tax increases and spending cuts). Positive: the deficit would ultimately fall. Negative: potential recession
2. They can delay some or all of the scheduled tax increases and spending cuts, adding to the deficit but de-risking the chance of recession (see Diagram 1 – Building a bridge to nowhere)
3. They could take a middle course, opting for an approach that would permanently cancel some of the proposed spending and tax-break cuts giving the economy some breathing room.

Can a compromise be reached? Republicans want to cut spending and avoid raising taxes (particularly on the wealthiest Amercians), whilst Democrats are looking for a combination of spending cuts and tax increases. Cleary both sides want to avoid the cliff, but we believe that there is a very high likelihood that Congress won't act until the very last minute and both parties are playing a huge game of "call my bluff" as they try to score points ahead of any agreement. It does seem though that there is appetite for crafting the $4 trillion deficit reduction plan that is badly needed in the longer term.

Therefore we believe that it's options 2 or 3 that are the most likely. By pursuing **option 2** (a 6-12 month bridge into 2013 of the various tax and spending issues) Congress will be simply kicking the can down the road. **Option 3** is a better solution but this depends on Obama working with Congress and taking a "Bipartisan" approach with his Republican counterparts.

In other words – it's time to haggle.

Height Analytics Fiscal Cliff Negotiations -- Calendar of Events						
Week of November 25th -- No Solution						
Expect staff level negotiations throughout the week; a cohesive plan is unlikely to emerge but rather a piecemeal release of negotiated components are likely as key members indicate their parameters on issues of jurisdiction.						
Week of December 2nd -- No Solution						
Draft legislation may begin to circulate between committee's of jurisdiction including House Ways & Means; Senate Finance; House & Senate Budget. Expect CBO and JCT revenue scores of various proposed bills begin being released for consideration of Administration and leadership.						
Week of December 9th -- Earliest Possible Week for Solution						
Challenging rhetoric and partisanship may continue in the early part of this week as members continue back-room negotiations on a key offsets and pay- fors for the legislation. Firm yea and/or nay votes may become clear this week.						
16-Dec	17-Dec	18-Dec	19-Dec	20-Dec	21-Dec	22-Dec
Leadership will be in final stages of whipping members to determine final vote tally and making minor adjustments to specifics to garner votes			Likely days of final votes in the House and Senate. Significant back and forth may occur, but end will likely be in sight.			
23-Dec	December 24-December 31					
Final day of votes pre 2013	Congress extremely unlikely to be in session, regardless of status of negotiations.					

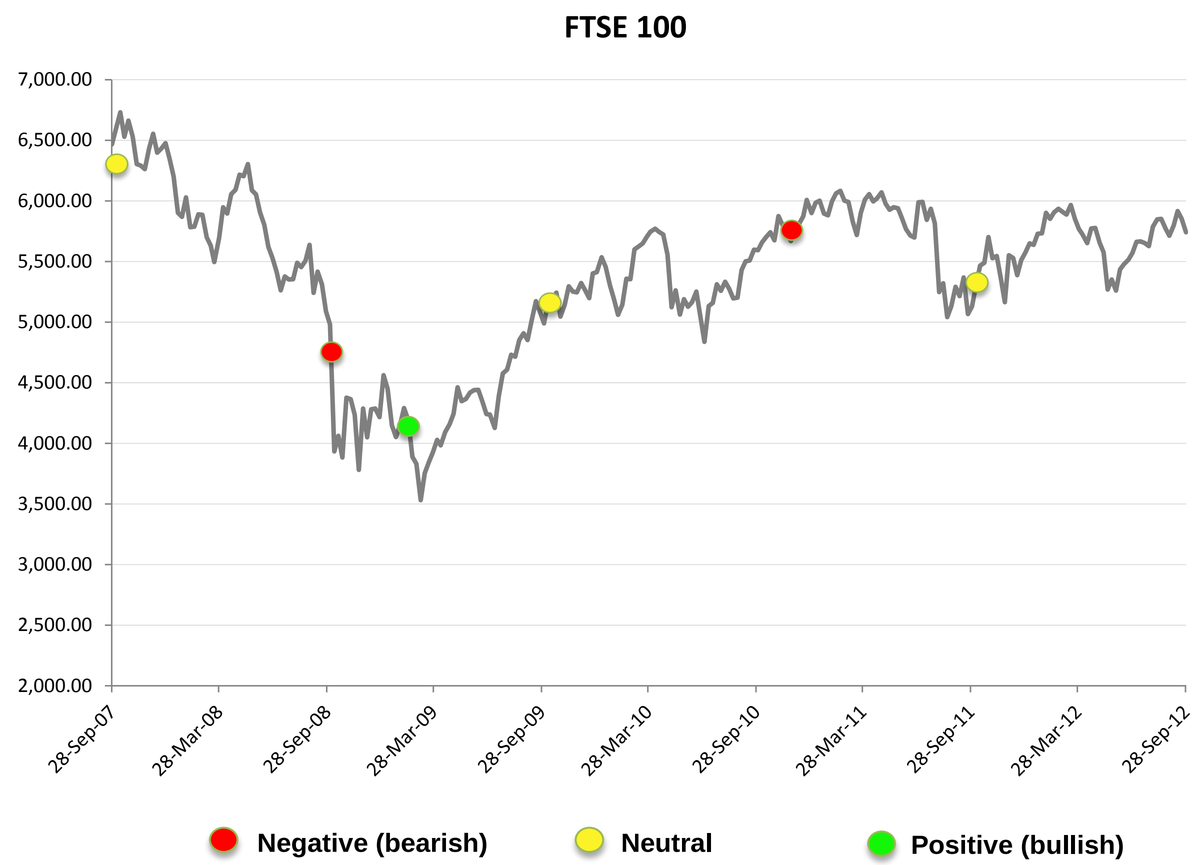
Source: Height Analytics, LLC

What does this mean for equities? The markets know that a compromise must be reached, as the alternative would be economic suicide. Therefore we believe that an amicable short term solution has **already been priced in** to equity market valuations. This does mean though that if a compromise isn't reached equity markets could drop dramatically in the short term.

Market "Stance"

At Mountstreet Partners we position our clients' portfolios to reflect our outlook for equity markets over the coming quarter.

The chart below illustrates our current "market stance" which is **NEUTRAL.** Each of the dots on this chart represents a change in our market stance.



It is unthinkable that a compromise on the Fiscal Cliff will not be reached.

With this in mind **The Mountstreet Partners outlook currently remains NEUTRAL.**