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QtrNotes

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Asset Security and Wire Fraud

Schwab and other custodians have recently sounded the alert on a new, rapidly growing scam targeting clients of banks, brokers, and investment advisors. Known as 'email intrusion wire fraud,' it begins with a client's hacked email account. The hackers use information found in emails to pose as the client and send fraudulent requests for cash, usually asking for wire transfers and claiming some form of emergency as a pretext.

In response, Schwab has increased its vigilance and scrutiny of all wire transfers. At Firestone, we have reviewed our own procedures to make certain that we're keeping your personal information, and your assets, safe.

Given the heightened scrutiny, if we receive balance inquiries or cash requests by email from any client, we will contact you directly and personally to verify the request. This may mean delay or inconvenience, and we ask for your patience.

Unprecedented Action and Plain Speech from the Fed

The US economy continues to improve. Since October 2009, GDP growth has averaged 2.3%, we've added 3.7 million jobs, the unemployment rate has fallen 2%, residential construction has expanded threefold, and corporate profits have nearly doubled. But given the depth of the sinkhole the economy has to climb out of, these numbers aren't good enough to satisfy either the country or the Federal Reserve. After its September meeting, the Fed acknowledged the recovery but announced that even more aggressive stimulus would be necessary.

"Having weighed the various tactical and strategic arguments of his officer corps, our helmsman, Chairman Bernanke, decided to call down to the engine room and request that more coal be shoveled into the economy's boilers," said Richard Fisher, President of the Dallas Federal Reserve. The Fed is keeping interest rates effectively at zero and launching a third round of Quantitative Easing, the program in which the Fed buys bonds to bring interest rates down for all borrowers, particularly home buyers. What makes this recent announcement truly historic is its scale: the Fed has committed to providing a nearly unlimited amount of stimulus to the markets until it is no longer necessary. We will know the end is near after we cross the finish line.

With the economy clearly recovering, why such aggressive action? Because, while economic activity continues to expand at a moderate pace, jobs are not being created quickly enough. Household net worth has improved, but personal incomes have not kept pace. While consumer spending is slowly increasing, business investment is slowing. Today's economy is like a jet plane speeding up to take off, but lacking the ultimate thrust to escape the runway.

Are friendly skies ahead? There is considerable reason for optimism, most notably a still-nascent housing recovery, a growing domestic energy sector, and a continually supportive central bank.

Index	*9/30/2012*	*YTD*
Dow Industrials	**13,437.13**	**10.0%**
S&P 500 Index	**1,440.67**	**14.6%**
Russell 2000	**837.45**	**13.0%**
MSCI EAFE	**1,510.75**	**7.0%**
Global Bond Index	**468.20**	**4.8%**
10-Year Treasury yld	**1.6%**	

Two dark clouds hover in the distance. One major headwind is Europe's efforts to resolve its significant debt imbalances. Europe has shown improvement this year, and the European Central Bank has pledged unwavering support to ensure the viability of the Euro. Although the region continues to face meaningful structural issues, European stocks rallied on the news.

But the primary risk is poor fiscal policy out of Washington which could send us off the "fiscal cliff," triggering another recession. (See next article.) The Federal Reserve, which controls only monetary policy, is doing all it can to stimulate economic growth. It is Congress that is responsible for fiscal policy, and Congress has done nothing to encourage businesses to deploy what Fisher calls the "copious liquidity the Federal Reserve has provided."

Off the Fiscal Cliff:
What It Is and Where It Might Lead

Last year, when Congress struck its eleventh-hour deal to raise the debt ceiling, the agreement provided for a super-committee, which had to formulate a plan to cut the budget deficit. The committee failed to reach agreement. Unless some action is taken, automatic cuts will be triggered in both defense and discretionary expenditures in 2013. These budget cuts, along with the expiration of the Bush-era tax cuts and the end of fiscal stimulus measures such as the payroll tax cuts and extended unemployment benefits, could potentially result in a 4%-5% decrease in the GDP.

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From the Fed:

"[The Fed] is doing everything it can to encourage the U.S. economy to steam forward. When we meet, we consider views that range from the most cautious perspectives on policy, such as my own, to the more accommodative recommendations of the well-known 'doves' on the committee. We debate our different perspectives in the best tradition of civil discourse. Then, having vetted all points of view, we make a decision and act.

"If only the fiscal authorities could do the same! Instead, they fight, bicker and do nothing but sail about aimlessly, debauching the nation's income statement and balance sheet with spending programs they never figure out how to finance.

"I am tempted to draw upon the hackneyed comparison that likens our dissolute Congress to drunken sailors. But patriots among you might take umbrage, noting that a comparison with Congress in this case might be deemed an insult to drunken sailors."

Richard Fisher, President of the Dallas Federal Reserve

Last Chance to Give Away Free Money

Money is never "free", is it? Well, it could be, sort of. Let us explain. Before we face a possible fall off the "fiscal cliff" on January 1st (see other article), we currently have an unprecedented opportunity to give large amounts of money away – for free!

Okay, so let's explain what "free" actually means. Free means free of gift tax. The government imposes a gift tax of 35% when large sums of money are given to another person – including your kid! Now don't panic: there are exceptions to this. First, spouses can give any amount to each other without penalty or tax. Second, anyone can give anybody a gift up to the annual exclusion amount, without triggering the gift tax. (Thank goodness for this, otherwise Santa Claus would be in trouble with the IRS!) The annual exclusion amount for 2012 is $13,000 per person. For example, two parents can give $13,000 each to a child for a total of $26,000. Or, if you win the lottery and are feeling generous, then you could give $13,000 to every person walking down the street – tax-free. This $13,000 person-to-person allocation is called the annual exclusion.

What happens if you give more than your annual exclusion to a person this year? The gift could still be exempt of gift tax, thanks to another type of exclusion: the lifetime estate basic exclusion. Part two of the government's gift tax exclusion allows for a "running tab" of gifts that can be made over a lifetime. Traditionally, this has been $1 million per person, but for 2012 the lifetime exclusion is an unprecedented $5,120,000, or $10,240,000 per married couple! As an example, let's say that you gave $23,000 to your child for a home down payment. Of that, $13,000 would be applied to the annual exclusion for that year, but the extra $10,000 could either be taxed at the 35% gift tax, or to avoid the gift tax it could be applied to the lifetime exclusion, leaving you with $5,110,000 after the deduction. However, as the lifetime exclusion is scheduled to drop in 2013, next year, you would be left with only $990,000 of your exclusion.

Yes, you heard that correctly. While you can give a lifetime amount of $5.1 million all in 2012, it is scheduled to reset to $1 million in 2013. Quite a difference! This is likely to be a use-it-or-lose-it opportunity. For those married couples in a position to give away up to $10.2 million to their children, these last few months of 2012 could be a rare opportunity. Yes, yes, very few are in that position, but the ten million number is just the maximum. For singles or couples with estates that will be over two million dollars, this 2012 gifting opportunity may be useful in reducing your estate taxes before the extra-large gifting window closes.

Off the Fiscal Cliff

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This scenario is the "fiscal cliff." Without some action from Congress before the end of the year, the economy could go off the proverbial cliff. The result would be major slowdown in economic activity and dislocation in the financial markets. With current economic growth a meager 2%, an additional 4% hit would throw us back into recession.

$600 billion in expiring tax cuts and mandatory spending cuts are at stake. Congress will not act before the election, so regardless of the outcome on November 6th, a solution must be cobbled together in the lame-duck session after the elections and before the start of the 113th Congress.

Economists are looking at four scenarios:

1. The Grand Bargain: the White House and Congress agree on a deal covering taxes, spending, and fiscal issues for the foreseeable future. Not likely.

2. A Modest Compromise: the White House and Congress reach some interim solutions to the questions of spending and taxes. What a compromise would look like depends on the results of the election.

3. Over the Cliff: if Congress and the White House can reach no agreement, then the Bush-era tax cuts expire and the spending cuts are triggered. The resulting blow to the economy would be profoundly damaging, making this the least probable of the scenarios.

4. Kick the Can Down the Road (or Punt): the most likely of the scenarios, in which the tax cuts get extended into the new year and the spending cuts are postponed until the new Congress has time to come to grips with tax and spending policies.

All is not hopeless. While the parties publicly posture and speak in talking points, discussions are taking place out of the glare of the cameras, trying to reach some consensus regarding tax and spending reforms, and revenue enhancements. As we suggested in an earlier issue, the ultimate resolutions may well look similar to the unsuccessful Simpson-Bowles report of 2010.

Despite the rhetoric, we remain optimistic that Congress will make progress in the coming months and in 2013. Any deficit reduction plan will have to include gradual reduction in spending coupled with a rational tax policy, to give the economy some breathing room until the private sector can pick up the slack and once again be the engine driving economic growth.