RYAN POAGE & CO.

INVESTMENTS | WEALTH MANAGEMENT

2012 RECAP, 2013 OUTLOOK JANUARY 2013

2012: FISCAL TIFF

Although many economic and market events occurred throughout 2012, economically, the year will be remembered for 11^{th} hour political squabbling over the Fiscal Cliff. This assortment of tax and budget issues was easier to comprehend than other economic issues surfacing during the year, and fittingly, the stock market was not overly impacted by the uncertainty. The market's muted reaction showed that the collective universe of investors correctly assumed that some type of deal would be brokered before the ball dropped in Times Square. The year saw plenty of drama and continued market volatility, however, from the ongoing debt debacle in Europe, the U.S. spinning its wheels during a pause in economic growth, and the slowdown and concern of a "hard landing" in China's economy. All of these events continued to increase investors' fear that another 2008 market meltdown is around each corner, which has resulted in ongoing overreactions to negative news. History has shown that investors have short memories, so fortunately, as time passes, this cause of increased market volatility should die down, which could reduce the market's roller-coaster feeling.

ECONOMIC ISSUES FOR 2013: CLIFF FALLOUT AND DEJA VU

The soap opera in Washington isn't finished in regard to the Fiscal Cliff, in that the deal just brokered only addressed the tax aspect of the Cliff issues. We still get to witness showdowns over the debt ceiling limit (the tiny issue of the country being on track to run out of money in a couple months) and big rounds of government spending cuts (which are feared to add to our unemployment problem). Since the market has already witnessed a debt ceiling showdown (Fall of 2011) and brushed off the Cliff issues, there's a good chance that the upcoming uncertainty won't create as much market volatility as it might have a year or two ago. Of greater immediate economic concern is the 2% pay cut that the average American worker has just taken. One of the many tax changes for 2013 is the reinstatement of the full social security payroll tax. During 2011 and 2012, the tax was temporarily reduced by 2% as a means to stimulate the economy. It was only supposed to be for one year, but with the economy still very weak, it was extended for 2012 as well. Human nature being what it is, it is a safe assumption that most workers have grown accustomed to the additional income (essentially a temporary raise) received during each of the 52 payroll cycles over the past two years. This potentially surprising pay cut won't derail consumer spending, but it is likely to result in a temporary decrease in spending as workers digest it. In the short run, a potential reduction in consumer confidence, coupled with a quarter or two of lowered spending, could cause a pullback in the stock market. Lastly, the other visible issues for 2013 continue to be the tired stories of the European debt crisis and whether or not China will slow down its pace of buying up stuff from around the world.

POSSIBLE INVESTMENT MARKET SCENARIOS FOR 2013

As usual, the current investment environment is a mix of both positive and negative themes. Looking at it from the half-empty glass viewpoint, the upcoming showdowns in Washington, social security tax induced pay cuts, high levels of investor fear, slower population growth due to an aging population, ongoing household deleveraging, and the continued state of high debt-to-economic output levels all add up to a formidable combination of short and long term headwinds for the stock market. The last three items are longer-term, big picture issues that will definitely create challenges for the market over the years, but are unlikely to directly influence the market in any given year. The first three headwinds are much more likely to result in downward pressure on the market as they unfold throughout the year. As far as problems, an elephant in the room is the impact that future increases in interest rates will have on the housing market. Long term fixed mortgage rates have been in the low 3% range for long enough that a substantial percentage of the population has taken advantage of the low rates through buying a new house or refinancing an existing mortgage. Just as falling rates over the past 30 years have allowed home prices to increase faster than inflation (reaching turbo-charged growth during the rapidly falling rate period between 2000 – 2003), increases in rates reduce the amount buyers can afford to pay. For example, a $200,000 mortgage for 30 years at today's 3.35% typical rate would result in monthly payments of principal and interest of approximately $881. Adding in taxes and insurance would likely increase the amount to $1,214. If rates were to increase to a still-low 5%, the total payment would increase to approximately $1,406. At a still-normal/low rate of 7%, the payment would be about $1,663. Obviously, if these increases occur without offsetting gains in wage inflation, the housing market will likely be dead in the water for a long time.

As bad as all that sounds, the glass can also be viewed as half-full. Regarding housing, in our slow-growth economic environment, interest rates are not likely to dramatically increase overnight. Nationally, the housing market has officially turned the corner with increases in home sales, prices, and new construction. Home construction is a special industry in that each new house that gets built creates a lot of spinoff activity (transactions for real estate agents, mortgage brokers, insurance companies, furniture purchases, etc.). From 2006 to 2011 the decline in homebuilding had a disproportionately negative impact on the economy. However, its current resurgence is having a disproportionately positive impact. Also, after the immediate slowdown from Hurricane Sandy, the rebuilding will create jobs and economic growth . . . just as we saw with Japan's earthquake last year.

The U.S. is witnessing a resurgence in manufacturing, since foreign goods have lost some of their competitiveness in terms of price and quality. The energy industry is also going through a period of huge growth. (Even if this growth isn't sustainable, a long-term benefit is that it is leading more students to major in engineering, which will lead to future productivity-enhancing technologies.)

Finally, the Fiscal Cliff caused many businesses to delay purchases and expansion plans. The slowdown caused by this wait-and-see attitude will naturally evolve into increased activity as "catch-up" orders are placed.

Add it all up, and the continued momentum in the economy points to a cautiously optimistic outlook for the investment markets. At Ryan Poage & Co., we remain realistic about the investing environment and dedicated to the disciplined endeavor of working to be adaptable to the never-ending changes in the market.