February 2013
Market Commentary

The Fiscal Cliff

As widely expected, the U.S. did fall off the fiscal cliff – for one day. The House and Senate agreed to legislation that limits tax increases for most taxpayers while also averting various spending cuts scheduled throughout 2013. For most Americans tax increases were largely limited to the repeal of the 2% payroll tax holiday. The recent congressional agreement to delay the confrontation over the debt ceiling also avoids immediate pain. Still, the agreements signal progress and provides some certainty.

The disproportionate tax increase on small businesses is probably the biggest flaw to the new agreement (small businesses file as individuals and make up the majority of taxpayers categorized as "the rich". Good politics are rarely good economics). Increased taxes will continue to slow hiring. But, now that small – and large – business knows the rules, the increased certainty will enable planning which will at least partially offset increased tax rates.

Longer term, budget deficits are expected to fall which has calmed bond and stock markets. Next year, the deficit could decline to 6% of GDP and by 2015 could reach the post-World War II average of 3%. More importantly, after the recent rapid explosion of debt, spending restraint in Washington seems to be growing.

Regulation

Beyond new tax increases, another drag on the economy will be the flood of regulations accompanying the President's new term. Many regulatory implementations were held up pending the election's outcome. With Obama's victory, they will move forward. Increased regulation will focus mostly in areas in which Congress has limited say or signed off before the 2010 elections. Examples include tougher rules from the Transportation Department and expanded requirements for pipelines. New limits on carbon emissions for existing power generating plants will increase energy costs.

In financial services, a "boatload of financial and corporate restrictions" is coming (quote compliments of the highly respected *Kiplinger Letter*). And these regulations that dwarf the scope and scale of the original 1933 Securities Act are just the beginning. More regulatory rewrites are expected in 2014.

Business Confidence Rising

But in spite of the current challenges that grab headlines, progress in the economy continues. The Commerce Department reported that non-defense capital goods orders (excluding aircraft), a closely watched proxy for investment plans, edged 0.2 percent higher in December. Since most economists believe businesses delayed capital spending late last year because of uncertainty over government spending cuts and tax increases, the higher reading signals that most companies appear to be planning to expand their businesses. In addition, the investment plans proxy for November was revised higher to show a 3 percent gain.

Even small businesses appear to be a bit more optimistic. The fears of tax increases targeting small business drove sentiment to a 2 ½ year low in November. When it appeared that tax increases may not be quite as bad as feared, sentiment edged back up a bit in December.

Debt

Part of the reason for the optimism in the private sector results from its remarkable deleveraging over the past several years. In spite of Washington's largess, non-public debt has declined faster than public debt has risen. Total U.S. debt including government, corporate, and consumer debt has declined from its peak of 350% of GDP to 320%. The change in trajectory is significant, and the percentage decline is extraordinary. To my knowledge, total U.S. debt has never fallen this fast. And, more meaningfully, this puts more cash and spending power in the private sector which tends to make much wiser spending choices than government.

Hiring

While unemployment remains stubbornly high, it should continue slowly declining to around 7.0% by 2014. The housing recovery, exports, and private sector growth will continue, and should offset decreased consumer wages resulting from the increase in payroll taxes.

Energy

Recent growth contributions from the growing availability of cheap natural gas and U.S. oil should continue. In spite of claims that fracking and drilling could hurt the environment, there's essentially no evidence of harm. Even the EPA's recent ecological impact study reveals nearly no adverse effects. This is notable given that the EPAs current mandate makes it exceedingly sensitive to any hint of environmental impact. It appears very unlikely that the federal government will change course significantly, although some states will likely add regulations.

Pent up Demand

After vastly improving their balance sheets over the past five years, both consumers and corporations have money to spend along with tremendous pent-up demand. Sales of big ticket items such as homes, autos, and various larger ticket durable goods are expected to continue to climb. In December, durable goods orders jumped 4.6 percent, beating economists' expectations of only a 1.8 percent gain. Increased spending should help the economy move forward and avoid recession in spite of higher taxes and ongoing uncertainty.

2013 Growth

There's an old saying adapted to the world of computers that goes "What the hardware makers giveth, the software makers taketh away." This refers to the tendency in computers for hardware to improve dramatically, and yet software becomes so much more complex that machines don't speed up very much. We have a similar situation in the U.S. What the private sector, through consumers and corporate America, giveth, Washington takes away.

The good news is that the private sector is continuing to forge forward and progressing on multiple fronts, so a recession remains very unlikely. But, conflicted and largely hostile economic federal policy likely means that GDP will grow by only around 2% the first half of 2013. But, growth should pick up towards the end of the year as business and consumers adjust to increased policy certainty.

For investors, many asset prices remain historically low providing ample opportunities. Investors willing to filter out the noise and chatter of the popular press have been well-rewarded over the past several years with the stock market increasing over 72% from 2009-2012. And, opportunities still abound.

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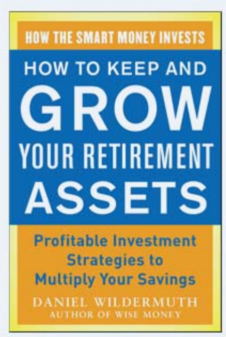

My new book was released in January. Like my previous book, this release identifies means by which individual investors can take better advantage of more advanced investment opportunities.

Wise Money, released last summer, helps individual investors adapt the endowment investing model employed by large universities to their portfolios.