December 2012 Market Commentary

Post election

The fiscal cliff is getting lots of attention for good reason. A deadlock would likely lead to recession by paring up to 4 percentage points from economic growth. The fiscal cliff results from approximately $600 billion in tax increases and spending cuts mandated by previous laws (some more than a decade old) that go into effect early in 2013. Many newsletters and media outlets will likely play off the worst-case scenarios, but an initial agreement on debt reduction, taxes and spending will almost certainly be reached.

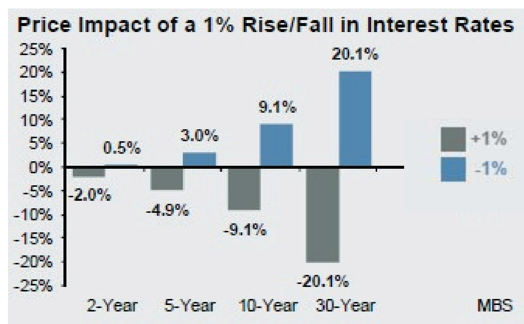
A deal will likely start with a revival of tax breaks that expired after 2011 including the fix for the alternative minimum tax and a short-term extension of all expiring tax cuts. These short-term agreements should buy time for a longer-term deal sometime in 2013. The later deal will likely address estate taxes, the debt ceiling, and automatic defense spending reductions. The surprising inclusion of Medicare in the fiscal cliff negotiations signals that lawmakers are taking negotiations on taxes and spending cuts seriously. Democrats want to spare the program, but any serious budget discussion must include them.

Near-term

Third quarter GDP was stronger than expected because of federal spending and oil and gas drilling. Unfortunately, fourth quarter will very likely be disappointing for several reasons. Uncertainty associated with the fiscal cliff will curtail investment and add to headwinds from expected cuts in government spending and hurricane Sandy's short-term disruption. Investors should be well served by looking past the next couple volatile months.

Stocks versus Bonds

The market recently paused as much because of disappointing numbers from corporate America as the elections. Recent profits have exceeded expectations, but sales have not. With 440 of the S&P 500 companies reporting, Thomson Reuters I/B/E/S said 63.4% of the companies beat their consensus profit estimates while only 37.6% topped revenue expectations. Partly as a result, valuations for stocks remain fairly attractive. S&P Capital IQ calculates a price-earnings ratio of 14.15 for the S&P 500. This equates to an earnings per share of stock of 7.1%. In contrast, the benchmark 10-year Treasury note yields 1.63% and the 30-year bond yields 2.75%. Bill Gross (the bond king who manages the world's largest bond fund) warns in his recent monthly commentary that he expects bonds to be "burnt to a crisp."



The problem is the limited upside offered by today's low interest rates versus the significant downside presented by possible interest rate increases. A 10-year treasury bond trading at par with a coupon of 1 5/8 yields 1.625%. If events caused investors to flee into bonds and the resulting 10-year yield fell to a record low of 1.25%, the price would still only appreciate to $103.50. Conversely, if 10-year yields were to rise to only 2.50%, which seems likely at some point, the bond value would drop to $92.30. An unlikely upside of 3.5% is little compensation for a probable eventual interest rate rise that would drive bond values down. The chart shows several additional scenarios. Keep in mind that a fall in interest rates of 1% seems extremely unlikely while an eventual rise of 1% or more appears inevitable.

Longer Term

After five years of collapse and stagnation, the economy is likely to pick up speed after the fourth quarter for several reasons. Of course, this continues with the earlier assumption that Washington doesn't derail the economy through the inability to reach a deal.

Productivity is way up. Since the start of the recession, GDP has increased 6 to 8% with 5 million less workers employed. The economy is much more efficient and entire sectors are sitting on piles of cash waiting for growth in demand. Since Oct of 2011, every sector of the economy has added jobs except for the federal government (preparing for sequestration) and media/information which has lost jobs every month since 2000.

International demand is looking more attractive. China's economy is growing more rapidly again as manufacturing is expanding at a more rapid pace. The risk of derailment by developed country implosions continues to lessen as Europe slowly struggles forward.

Housing starts are up 45.1% from a year ago and were up 15% in September. The readings were the highest since 2008 and home builder confidence is at a five year high. People are also putting more money in remodeling with a greater focus on higher end additions. In 2013 and beyond, housing should boost GDP and job growth significantly.

Rising consumer spending should also boost GDP growth. Consumers have dramatically deleveraged and are increasing spending at an accelerating pace. And the economy has a lot of pent up demand. The used car market was already thin before hurricane Sandy, and inventory continues to shrink. New car sales have risen 13% this year and household formation, which drives a wide range of additional spending, is also up.

Domestic energy production continues to climb strongly. Between 1986 and 2008, domestic oil production fell 41% and declined nearly every year over these two plus decades. Over the past four years it is up more than 30%, and it has since risen consistently for the first time in three decades. The U.S. produced more oil in July than in any other month since 1998. Growth in America's energy output since 2008 has surpassed all countries in the world.

The boom in natural gas production is even more impressive. New fracking technologies and a push to find new supplies after the 2008 energy shock have driven domestic natural gas production to an all-time high in January, up 35% from five years ago. Increasing supply has pushed prices down by around 70-80%. The trend should continue to transform the economy. Rising domestic energy production has already shaved $175 billion off our annual import bill compared with five years ago, and 1.3 million new energy-related jobs are projected for the next seven years.

As during most times, and particularly during times of heightened uncertainty, the **best investment strategy likely remains staying diversified and looking long-term.** Today's circumstances appear no different. The short-term will likely be rocky, while the longer term outlook appears both more stable and positive.

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