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MARKET COMMENTARY

The Fiscal Cliff

As of this writing, it's still not clear whether or not the U.S. will go over the fiscal cliff. However, while a grand deal may not be reached by the January 1 deadline, some form of agreement should materialize shortly. If a comprehensive agreement isn't reached, which seems probable at this late stage, we will probably see a series of scaled down piecemeal agreements. What does this likely mean?

The imagery evoked by the term "fiscal cliff" is highly misleading. Without any form of agreement, as of January 1, the U.S. starts down a gradual fiscal slope, rather than stepping off a cliff. The effects of no progress would only slowly make an impact, and later partial agreements can easily move the U.S. off a downward trajectory and back on to the slow growth path we've been on for the last several years.

The biggest damage inflicted by the fiscal cliff or poorly structured agreements likely remain the ongoing uncertainty associated with the lack of clear tax, spending, and debt ceiling policies.

This past Thursday, I was interviewed by the ABC local Atlanta news affiliate regarding the fiscal cliff, and much of the segment focused on the challenges that small businesses face in planning for the future given the lack of policy structure. Of course, these same challenges affect nearly any organization, large or small, leading to much lower investment and spending. Congress's inability to reach a credible agreement is already impacting the economy, but the damage should be limited if Congress can create a credible plan going forward. However, just as the government has slowed the recovery through various forms of increased regulation and policy uncertainty, this is just one more hurdle that the private sector should be able to successfully navigate, even if it acts as yet another drag on growth.

Retail Challenges

Fears associated with the fiscal cliff appear to have claimed its first major casualty. The 2012 holiday season will likely be the worst for retailers since the 2008 financial crisis as consumers cut back substantially because of a foggy policy future. Sales growth came in well below projections and it's likely that many retailers will discount current inventory to unload unsold merchandise. Shoppers take note. There should be a lot of deals out there!

While discount chains such as Wal-Mart and the Gap are believed to have done well as shoppers emphasized lower pricing, retailers not focused on the bargain segments appear to have struggled. Poor sales reports through the holiday season have driven the share prices down for most retailers.

Positive Trends

Housing: Looking beyond challenges that center in Washington, various trends offer encouragement. In November, contracts to buy previously owned U.S. homes rose to their highest level in 2-1/2 years. Pending home sales were up 9.8 percent in the 12 months through November. The levels are the highest reached since April 2010 when the home-buyer tax credit expired.

Since the recent increase results from demand driven market forces rather than artificial government stimulus, the trend should continue and is expected to strengthen. As home sales rise, builders are starting new construction projects that will also spur investment and hiring.

Europe: Many projected that Europe, and the euro, would implode in 2012. Instead of collapsing, the euro has rebounded against the dollar. Bond yields of struggling countries such as Greece, Spain, and Italy have all declined signally that the market believes these countries are becoming less risky rather than more so.

While problems still abound, even the most pessimistic prognosticators are revising their forecasts up. Europe has shown much greater commitment to keeping the euro intact than expected. Policy shifts in the second half of 2012 have bolstered the union even if many fundamental competitive issues remain. While much of Europe remains fundamentally uncompetitive, the likelihood that the continent will derail the global economy appears to be steadily lessening.

China: Increasing confidence in China's stabilizing economic growth led to Chinese stocks rising for the fourth week in a row. In addition, indications that the nation's new leaders will provide more industry support are contributing to investor confidence. The China Securities Journal reported that the government will try to boost consumption of household electronics, vehicles and solar for rural use. The Shanghai Securities News reports that the Ministry of Industry and Information Technology will introduce policies to boost the information industry. More robust and stable growth in China will help the U.S. directly and through the strengthening of the global economy.

Likely Problem Areas

Fixed Income: As the domestic and global economies appear to be slowly gaining momentum, bond investors need to be careful. Last year's decent returns appear nearly impossible to replicate given today's yields and returns. While inflation is likely to have little impact on the bond market in 2013, and it's unlikely that bond yields will rise dramatically in 2013, investors likely need to maintain low expectations and take precautions against inevitable rate rises.

Municipal Bonds: Muni's likely present investors more immediate danger. After a 6-month rally that pushed yields to a 47-year low, muni markets have struggled. Concerns abound including low current yields, default fears, and worries that the Congress may change the tax status of municipal bonds. Many Wall Street securities firms recently unloaded substantial municipal-debt holdings. Through December 19th, Muni's lost 1.5 percent in December resulting in the worst decline since the end of 2012, when Meredith Whitney set off a muni bond panic with her incorrect projections on a 60 Minutes interview. Given their limited upside and tax uncertainty, this sector offers little upside for substantial risk.

While there can be cause for concern about stock and bond markets, particularly in the near term, the domestic economy appears likely to continue its fitful lurching forward. Its progress should also be augmented by an increasingly stable global economy. As always, maintaining a long term focus remains wise, and should help make better decisions.

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