

January 2013

# ECONOMIC OUTLOOK

## Summary

The economy begins 2013 having moved past the “fiscal cliff” and is in relatively good shape. The final reading for third-quarter gross domestic product showed the economy did better than thought, as growth was revised higher to 3.1%. The fourth quarter most likely was a bit slower due in large part to the problems in Washington and their impact on confidence. However, activity appeared to pick up in December, as both the Institute for Supply Management manufacturing and non-manufacturing indexes increased. The manufacturing index was once again above 50, indicating growth in that segment of the economy. The increase in the non-manufacturing index may be more important due to the large part of the economy it represents. Its increase can be tied to improvements in the housing sector and a brighter holiday shopping season.

Consumer sentiment went into the new year having fallen in December. The decline was due almost entirely to expectations going forward, as opposed to current sentiment. The passage of tax legislation to avert the fiscal cliff probably did not do much to change these views, as consumers most likely will have less disposable income. This is the concern for the first half of the year. The increase in taxes, including the payroll tax reverting to a higher level, is likely to have a negative impact on consumer spending. While gains continue in non-farm payroll numbers, they are very modest, which is likely to hold back any meaningful reduction in the unemployment rate. With less disposable income and a lackluster job market, consumer confidence could be expected to be a bit muted.

The continued supply of liquidity by the Federal Reserve and the improvements in manufacturing and non-manufacturing should help the economy continue to show gains. Growth is expected to slow as the consumer holds back, but gains in housing and a modest improvement in the job market should help. Ongoing improvement in foreign economies should also contribute to our economy, but the positives may not show up until the second half of the year.

### POSITIVES

- ❑ ISM manufacturing index above 50, indicating growth in that segment
- ❑ Continued improvement in the housing market, with sales up and prices improving
- ❑ Durable-goods orders and industrial production show nice gains

### NEGATIVES

- ❑ Decline in Conference Board’s consumer sentiment index
- ❑ Decline in leading economic index in November
- ❑ High unemployment rate and modest gains in non-farm payrolls

### UNKNOWNNS

- ❑ Ultimate impact of tax legislation passed to avert fiscal cliff

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# EQUITY OUTLOOK

## Summary

Equity markets turned in a very respectable performance in 2012. Scaling a large wall of worry, the S&P 500 managed to gain 16%. International markets recovered sharply from a near meltdown last summer, as the MSCI EAFE index of developed markets outside North America rebounded and closed the year up 17.9%. Financial stocks outpaced market gains, up 26.3% as the big banks recovered from depressed levels. The consumer discretionary sector followed with a 21.8% return. Utility stocks, reacting to concerns of a return to higher tax rates on dividends, slipped 2.9% for the year (sector returns are price only).

With headline events of last year behind us (remember the election?), we turn our attention to the possible trajectory for equities in 2013. Folk predictors aside (Superbowl outcome, presidential cycle and hemlines), we choose to focus on Federal Reserve policy and the direction and magnitude of corporate earnings. Regarding the Fed, we conclude that a pro-growth policy of accommodation will continue, despite recent disagreement regarding the duration of QE3. Corporate earnings most likely closed the year on a softer note than expected, as the impact of Hurricane Sandy continued and uncertainty surrounding the “fiscal cliff” resulted in a pause in some business plans.

Nonetheless, positive momentum in the U.S. housing and automotive sectors, which include big-ticket items with great spillover into the overall economy, should continue this year. Growth estimates for Europe have been ratcheted down for several months, so even some stability there would be positive. Emerging markets, led by China, have managed a soft landing so far. We expect corporate earnings to be up slightly in 2013, perhaps on the order of \$105 a share in the aggregate for the S&P 500. With this market priced at 1,460, investors are capitalizing earnings at just 13.9 times forward earnings, which is still a reasonable value.

### POSITIVES

- ❑ Monetary policy accommodative to growth
- ❑ Inflation stable

### NEGATIVES

- ❑ Upcoming political fight over debt-ceiling extension
- ❑ Employment growth still below historical recovery levels

### UNKNOWNNS

- ❑ European sovereign-debt issues

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# FIXED INCOME OUTLOOK

## Summary

The most important question in the new year for bond investors is whether the extraordinary actions taken by the Federal Reserve and European Central Bank will prove sufficient to suppress the systemic risks that have plagued markets for the past two years.

A premature halt to the Fed's Treasury and mortgage purchase program and the untested nature of the ECB's "outright monetary transaction" (OMT) program are clear risks for the markets. A ratings downgrade resulting from unproductive talks over the U.S. debt ceiling and/or Spain getting dragged into the OMT program with its attendant need for even more austerity measures would be highly disruptive.

We believe that a resilient U.S. economy will weather the headwinds stemming from higher personal taxes and political dysfunction. GDP should grow 1.75% to 2.25% this year with a benign inflation backdrop. Corporate profitability may set a cyclical high this year and credit metrics remain favorable. We expect a trading range to prevail this year in the Treasury market, consistent with what has been observed over the last 12 months. Our portfolios remain overweight corporate credit and we believe that this sector will provide the greatest excess return this year.

### POSITIVES

- ❑ Global economic growth moderating
- ❑ Inflationary outlook benign, well within target ranges
- ❑ Fed scheduled to make significant additional asset purchases

### NEGATIVES

- ❑ Current yield levels lower than expected inflation; TIPS yields negative
- ❑ Bond yields reflect significant flight to safety and manipulation by the Fed

### UNKNOWNNS

- ❑ European financial crisis and path to resolution
- ❑ Debt-ceiling talks and outcome
- ❑ Investor flight from riskier assets