

December 2012

# ECONOMIC OUTLOOK

## Summary

The U.S. economy grew in the third quarter, as the Commerce Department revised real gross domestic product to an increase of 2.7% versus the originally reported 2.0%. The main reasons for the upward revision were better growth in housing, government spending and inventories.

Since the end of the quarter, the economy has shown positive signs that growth most likely will continue, even though it is expected to be rather slow. The numbers for October reflected the positive momentum from the third quarter, while the initial numbers for November painted more of a slowdown picture. Hurricane Sandy had a negative impact at the end of October and the beginning of November, but the “fiscal cliff” has played a more important role. The lack of a budget agreement seems to have had more of a negative impact on manufacturers than on the consumer. The Institute for Supply Management’s manufacturing index fell in November to below the 50 level, indicating that growth was contracting. Companies are taking a wait-and-see approach and are holding off on production, expansion and hiring decisions. Even though the “fiscal cliff” has the potential to increase taxes for consumers, the consumer has been more positive. Improvements in the housing and labor markets have bolstered the consumer’s attitude about the economy.

Where the economy goes from here, especially next year, most likely will depend to a great degree on how Washington addresses the budget. It appears taxes are likely to increase, but we don’t know to what degree. Still, we continue to believe the economy will avoid going back into recession. Growth most likely will continue to slow, but slow positive growth is much better than negative growth.

### POSITIVES

- ❑ Increase in ISM non-manufacturing index, representing largest part of economy
- ❑ Rise in Conference Board’s Consumer Confidence Index to highest level since February 2008
- ❑ Additional signs of improvement in the housing industry
- ❑ Reduction in the unemployment rate and increase in non-farm payrolls

### NEGATIVES

- ❑ Decline in the ISM manufacturing index below 50, indicating contraction
- ❑ Decline in industrial production in October
- ❑ Continued problems and slowdown in foreign economies

### UNKNOWNNS

- ❑ Resolution of the budget talks and the economic impact

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# EQUITY OUTLOOK

## Summary

U.S. stock markets wasted no time after the election in selling off as a result of the looming “fiscal cliff.” This came in anticipation of higher taxes on dividend income, especially for high-yielding stocks. The S&P 500 managed to eke out a 0.28% gain in November. Three of the four sectors that lost ground ranked highly in dividend yield: Utilities gave up 4.9%; energy lost 1.8%; and telecom slipped 0.9%. The best-performing sector was consumer discretionary, which gained 3%.

The battle has been joined between congressional Republicans and the president as to how to address the automatic tax increases and sequestration spending cuts scheduled to take effect Jan. 1. While we anticipate some combination of immediate concessions and “kicking the can,” this drama likely will dominate the remainder of 2012 as it is played out in front of an eager media and a concerned public. The risk to consumer confidence could be great if the debate drags on.

The fundamental underpinnings of the U.S. economy are stable, but weak. Third-quarter gross domestic product was revised up to 2.7%, but the increase was due primarily to growing inventories and government spending, not final demand. Job growth is positive but anemic. Wage growth is stagnant.

As the year winds down, we begin to dust off the crystal ball and peer into the haze of 2013. Sandy delivered a wallop to the East Coast that will dampen consumer spending for months. European countries will deal with fiscal austerity consequences for some time to come. We expect modest growth worldwide next year, driven mostly by emerging and frontier economies. Corporate earnings modestly above 2012 levels, along with pro-growth monetary policies globally and an incredibly expensive bond market, provide a benign backdrop for equities.

### POSITIVES

- ❑ Monetary policies remain pro-growth
- ❑ Election uncertainty resolved

### NEGATIVES

- ❑ “Fiscal cliff” resolution that increases federal deficit
- ❑ Europe stumbles as it addresses debt issues

### UNKNOWNNS

- ❑ Global impact of Middle East turmoil

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# FIXED INCOME OUTLOOK

## Summary

The bond market continued to be held hostage by the “fiscal cliff” follies and the European debt crisis. After trading in a narrow range for the past few months, rates are unlikely to move significantly in either direction until there is some resolution to both issues.

In the U.S., taxes and spending have been the primary focus of market participants as they evaluate potential outcomes to budget talks and the impact on economic activity and funding. If the impasse continues and we go over the so-called cliff, then the economy will likely enter a recession and rates could break through the recent ranges on the low side. If a credible plan is achieved that reduces the long-term debt yet creates an environment for business activity to expand, then rates could break out to the upside. The most likely outcome is that the can will get kicked down the road or that a moderate package of spending cuts and tax increases is agreed upon that does little to curtail the budget deficit. In this case, the U.S. likely will be downgraded again, but yields aren’t likely to react much.

Across the pond, the European debt crisis appears to be quieting, but not much has been done to address the fundamental issues of indebtedness and uncompetitive business environments. While many believe that the new debt purchase program by the ECB will be the “Holy Grail” to resolve their issues, we remain skeptical. Further worsening of the crisis would cause rates to drop.

### 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

- ❑ Uncertainty in European financial crisis and path to resolution
- ❑ “Fiscal cliff” discussions and outcome
- ❑ Investor flight from riskier assets