

February 2013

ECONOMIC OUTLOOK

Summary

The first report on gross domestic product for the fourth quarter of 2012 showed the economy declined by 0.1%. This compared with the 3.1% growth in GDP for the third quarter. We must remember the first estimate of GDP includes mainly numbers for the first two months of the quarter. There are two revisions to come and it is expected these will most likely show a slightly better economic picture.

A big part of the decline can be traced to a sharp drop in government spending prior to the election and in the face of the “fiscal cliff.” The Institute for Supply Management manufacturing and non-manufacturing indexes remained above the critical 50 level, indicating they continued to show growth. The labor market continued to show positive growth in non-farm payrolls, even though the growth was not up to historical averages. However, the figures for the end of the year were revised higher, a good sign. The increases, though, were not enough to lower the unemployment rate. In fact, it recently increased slightly, as the growth encouraged more workers to re-enter the workforce. Another important segment of the economy, housing, also showed positive signs. Existing-home sales for 2012 were up over 9%, the strongest year for sales since 2007. In addition, the inventory of previously owned homes for sale fell to its lowest level since January 2001. It is hoped the ripple effect from housing will continue to provide benefits to the overall economy.

Consumer confidence rose through the end of the year, but declined in January as tax increases hit paychecks and Congress continued to debate an increase in the debt ceiling. Incomes rose dramatically in December, as companies paid bonuses early and declared extra dividends. This helped spending in December and we hope it will provide for additional spending opportunities in the first half of this year. Overall, the economic numbers showed an economy that continued to expand, just not at an aggressive rate. Some hurdles remained, but corporate America was in great shape and consumers took great strides to improve their financial condition. The Federal Reserve remained committed to low interest rates, another positive. While it may not be very strong, we expect economic growth to continue and hope it will improve as we go out into the year.

POSITIVES

- ❑ ISM manufacturing and non-manufacturing indexes remain in growth territories
- ❑ Housing market stabilizing to improving, with low inventories and better prices
- ❑ Durable-goods orders up in December

NEGATIVES

- ❑ Decline in Conference Board’s consumer-confidence index for January
- ❑ Higher taxes and higher gasoline prices may hurt consumer spending
- ❑ Rise in unemployment rate

UNKNOWNNS

- ❑ Ultimate resolution of debt ceiling and sequester talks and impact on economy

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EQUITY OUTLOOK

Summary

Uncertainty on tax rates, which had been hanging over equity markets ever since the election, was swept away by political compromise at the 13th hour, and investors voted with their approval. The S&P 500 gained 5.2% in January and global markets responded as well, as the MSCI EAFE index of developed markets outside North America also rose 5.2%. Energy and health care sectors turned in the best performance, up 7.6% and 7.3% respectively. Technology and telecom lagged, up only 1.3% and 2.2%. No doubt the rout in Apple's stock price in January had a negative impact on the tech sector (sector returns are price only).

Such a sharp move in markets in such a short time has added an element of frothiness to the landscape. Indeed, money poured into equity funds and exchange-traded funds of all stripes last month, notably dividend-paying funds, which were given a leg up thanks to the benign tax policy resolution. Setting current valuations aside for the moment, the backdrop for equities remains favorable. Monetary policies are positioned for growth and, domestically, are finding desired effects. We have long noted the domestic housing market, fueled by a record level of affordability, is on firm footing as new starts and sales remain robust. New orders for durable goods soared in December and job growth is positive, although at a level not sufficient to affect the unemployment rate.

The waning of geopolitically induced uncertainty (read euro collapse) has had a positive impact on global confidence. In fact, it has been observed that since the onset of the global financial crisis in 2008, asset valuations have responded more to policy decisions than to fundamental valuation factors. Hence the origin of the "risk on, risk off" paradigm, which came to dominate markets the past few years. Is that regime in decline? A few early signs may be a re-emergence of valuation-driven security selection in investing and a dissipation of the fear trade in riskless assets (U.S. Treasury notes) leading to a gradual rise in yields. Time will tell.

POSITIVES

- Fed policy accommodative
- Dividend tax rate uncertainty resolved
- Consumer confidence building

NEGATIVES

- Debt ceiling, sequestration still unresolved
- Markets overbought, insiders selling

UNKNOWNNS

- Can the federal spending issue be resolved?

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FIXED INCOME OUTLOOK

Summary

Interest rates rose in January by 15 basis points for the 5-year Treasury and over 20 basis points for maturities longer than 7 years. With Treasury bonds delivering a second month of negative returns, many forecasters once again are calling for an official end to the 30-plus-year bull market for bonds and the beginning of a great new bear market. We see the bond market trapped in a tug-of-war between forces keeping rates low and those that would push rates higher.

On one hand, there is increasing evidence that the economy continues to steadily improve. This is in spite of the recent “fiscal cliff” follies and the continuing budget and spending debates. Housing is rebounding, auto sales are increasing and the employment market continues to improve. European economies have avoided more severe economic contractions and China has resumed more rapid rates of growth. The firming economic backdrop should support real demand and could increase inflationary pressures. Inflation, of course, is the foe of interest rates.

On the other hand, the economy is still growing below what is believed to be its long-term potential, unemployment is still high and current inflationary pressures remain muted. Furthermore, budget and fiscal impasses could derail the recovery, and the potential for a systemic collapse in Europe is still present. But most importantly, central banks around the world are continuing to expand their balance sheets and add liquidity to the financial markets.

Overall, we do expect a trading range to prevail with the potential for a slight upward bias, but we do not foresee the onset of a major bear market for bond investors. Corporate credit fundamentals continue to remain strong, which would favor corporate debt, but event risk has re-emerged, which makes selection critical.

POSITIVES

- ❑ Inflation is well within target ranges
- ❑ Fed and other central banks continue to purchase assets
- ❑ Strong equity markets could cause rebalancing in favor of bonds

NEGATIVES

- ❑ Global economy improving
- ❑ Current yields lower than expected inflation
- ❑ Bonds reflect manipulation by central bank purchases

UNKNOWNNS

- ❑ Debt ceiling and budget negotiations, sequestration
- ❑ Secular shift to/from equities to/from fixed income