Financial Outlook for 2013

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Last year we wrote about the roller coaster ride caused by the European sovereign debt problems. While this "beast" is still in the picture, we predict that the 2013 financial markets will be driven more by earnings than by fear.

Earnings are relatively high, but the third quarter numbers were disappointing. In the 12 months ending in October 2012, the S&P 500 index rose about 13 percent. While this return was much higher than for the same period last year, we have lost about half of this gain since the election. It seems that the election was not a positive factor for the market. There are two possible reasons. One is that the market thinks the Obama administration will be less friendly to business in its tax and regulation policies. The second is that the market is concerned about the uncertainty from Washington. The election did not end the partisan bickering and markets do not like uncertainty. We cannot determine which factor is dominant but we expect that both are likely to continue. With this as a background, we turn to fundamentals.

Economic Fundamentals

Stock prices are a very good indicator of future economic activity: investors buy stocks anticipating the real economy will pick up in the near future. There are many positive signals that suggest optimism for 2013.

- Corporate earnings are still generally high. Third quarter earnings for 2013 were disappointing for some industries and companies, but more companies are reporting a positive earnings surprise than a negative one.
- Price-earnings (PE) ratios are close to historical averages, suggesting that stocks are not overvalued. The PE ratio based on current earnings for the S&P 500 is currently 15.9, just below the long-term average of 16. The PE ratio for the projected earnings of the S&P 500 is 12.6, which is below the average value of 14.3 over the past 10 years.
- Major U.S. banks are stronger than their European counterparts. The stories out of Europe are about the weakness of bank balance sheets mostly in Spain and Italy—but we hope not Germany.
- The Federal Reserve is continuing to keep interest rates low to fuel the economy. The Fed Funds target rate of zero to 0.25 percent will probably be maintained throughout 2013, and the 10-year bond rate will likely maintain its current range of 1.5 percent to 2.0 percent.
- The dollar has been strong since last year but weaker over the past three months perhaps in response to "quantitative easing III." Its current direction is a help for companies growing their exports. The dollar/euro has fluctuated around $1.30 in spite of the problems with European debt.
- Housing is the biggest potential upside as the market appears to have hit bottom and the excess from the housing "bubble" has been worked off. Through the first half of 2012, the Case-Shiller Home Price Index has risen 5.2 percent and new residential construction is up 5.6 percent.
- We think inflation will remain subdued. Our forecast of about 2 percent is slightly higher than most commercial forecasts.

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However, negative factors could make the market recovery short-lived:

- The immediate risk is the fiscal cliff which is, in case you haven't heard, the expiration of the Bush tax cuts, the payroll tax reduction and the reduction (called sequestering) of federal government expenditures on much of the federal budget. According to the Congressional Budget Office, taxes will rise from 15.7 percent of GDP in 2012 to 18.4 percent in 2013. Spending will fall from 22.9 percent to 22.4 percent of GDP. If we go over the cliff, we predict a recession in the first half of 2013 with a recovery by this time next year.
- Going over the cliff may shake the confidence of investors in the ability of the political system to respond to our long-term fiscal problems. On the other hand, it would cut the deficit by 50 percent, which may give the markets confidence that fiscal solutions are possible.
- Analysts are generally cutting earnings estimates for the fourth quarter of 2012 and early 2013. More companies are giving negative guidance and revenue forecasts are down. The surprising development

is that revenue numbers are much more disappointing than earnings. Over the past four quarters, 70 percent of S&P 500 companies have reported increased earnings over average estimates, but only 36 percent have reported a sales increase over average sales. This is the lowest percent since the first quarter of 2009. It is not clear whether these forecasts are based on the fiscal cliff.

- The European Central bank is still struggling with banks in Spain, Portugal, Italy and Greece. In addition, the International Monetary Fund currently estimates that the eurozone growth will be less than 1 percent for 2013. This is an improvement over 2012, but still represents very weak growth.
- Business investment is weak. In the third quarter of 2012, the growth rate of spending on equipment and software fell to zero. Companies have very large cash positions on their balance sheets, which may be related to policy uncertainty in Washington.
- The Conference Board Leading Economic Index is up only 0.2 percent for the past two months. In addition, a survey of CEOs from the Business Roundtable suggests increasing pessimism about future earnings and worldwide economic conditions.
- In spite of the recent upturn, industrial output is still only at 78 percent of capacity—well below the long-run average (including previous recessions) of 81 percent.
- The expansion of the national debt since the end of 2008 is unprecedented since World War II. By next year, the debt-GDP ratio will have doubled, from 40.5 percent to almost 80 percent. The massive government deficits may lead to fears of higher interest rates, accelerating inflation and slower growth in the future. These trends will have an adverse effect on business investment. The projected budget for 2012 is somewhat lower, about 7 percent of GDP. If the 2012 deficit is financed by tax increases, the tax bill will average about $3,500 per person.
- The U.S. still faces a huge funding deficit in Social Security and Medicare payments. The present value shortfall is about $62 trillion. This is equivalent to $206,000 per person or $825,000 per U.S. household. These problems are not insurmountable, but they do require common sense and bipartisan leadership—something that appears to be in short supply in Washington, D.C.

Forecast

Looking forward to 2013, the positives outweigh the negatives for the economy. We expect the recovery to continue, albeit at a rate much slower than a typical recovery, with both GDP growth and inflation in the 2 percent to 3 percent range. The pace of the recovery, however, will not improve until consumers have recovered enough to respond strongly. This process will extend beyond the end of 2013. Housing may be the largest potential upside, the world economy the biggest downside.

In this environment, we expect that the return to equities will be positive, regardless of whatever cliff we go over, but below the long-run average return of 9 percent. With Treasury bonds already at extremely low yields, there is little potential for gains with these investments. In addition, we think there are material long-term inflation risks which could make long-term bonds unattractive. In contrast, the low Treasury rates make mortgage rates extremely attractive, with 30-year fixed rates at 3.625 percent and 15-year fixed rates at 2.75 percent (at the time of this writing).

Summary

The U.S. economy appears to be heading to smoother waters, but unemployment remains a stubborn reminder of the recession. Partisan politics may continue to disrupt economic relationships especially for the fiscal cliff. The adjustment process to full recovery and full employment, however, will likely continue to take time. Until a complete recovery is in sight, we expect stock market returns to be positive, but below their long-run average.