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Advocacy Investing®

**APOCALYPSE NOT!**

- **2012: Calamity avoided, as compromise bill extends Bush-era tax cuts for all but the top 1%**
- **Data releases show a resilient consumer, a real estate revival and manufacturing on the mend**
- **Labor markets show dull but steady improvement, unemployment at 7.8%**
- **An early exit (before year-end 2013) from quantitative easing is a possibility**
- **Fiscal tightening should be offset by a dynamic private sector in next few months**
- **Continued policy gridlock is the major political risk in the near term**

Looking back at 2012, we can say that this was another year of calamities avoided. In other words, what did not happen was more important than what happened. The eurozone did not collapse, and the much-hyped fiscal cliff was averted thanks to a last minute compromise approved by Congress and signed into law by President Obama. However, the sense of relief should be tempered by the recognition that many of the issues the world faced in 2012 remain unresolved—at best, the proverbial can has been kicked down the road.

***Cliff? What Cliff?*** In retrospect, it has become clear that the threat of a "fiscal cliff" did little damage to the either economy or the financial markets. The main element of the compromise legislation, aka the American Taxpayers Relief Act (ATRA) of 2012 was the extension of the Bush-era tax cuts for all households except for incomes above $450,000 ($400,000 for individuals). The agreement top tax rate returns to 39.6% from 35%, taxes on dividends and capital gains rise from 15% to 20% for incomes over $250,000, and the estate tax rises to 40%, with an exemption threshold of $5 million. In addition, the legislation limits exemptions and itemized deductions for high income taxpayers. A "patch" for the Alternative Minimum Tax will also limit its impact on taxpayers. The ATRA also postponed the automatic spending cuts ($110 billion in 2013) for two months, and unemployment benefits were also extended for a year for 2 million unemployed people. In combination with the other elements of the agreement, taxes for the wealthiest taxpayers will increase sharply, making the new tax rates the most steeply progressive ones since the 1979 (Table 1).

**Table 1: Impact of Fiscal Cliff Agreement**

| Income Range('000) | <50K | 50K-100K | 100K-200K | 200-500K | 500K-1MM | >1MM |
|---|---|---|---|---|---|---|
| Tax Increase($) | 297-579 | 821-1,206 | 1,784 | 2,711 | 14,800 | 170K |

These measures will raise revenues by a projected $700 billion over the next decade. Moreover, with the end of the 2% payroll tax exemption (Social Security taxes are collected on incomes up to a ceiling of $113,000), taxes will go up for almost everyone. Overall, while the in-extremis passage of the compromise legislation avoided a potential financial shock, most issues remain unresolved. While President Obama is negotiating from a stronger position, the immediate resolution of the fiscal cliff position is only the first of several potentially difficult confrontations with the incoming Congress. First, Congress needs to immediately raise the federal debt ceiling, which was reached at the end of 2012. Second, Obama and Congress have to agree on spending cuts. The GOP-dominated House of Representatives has promised tough confrontations on both issues.

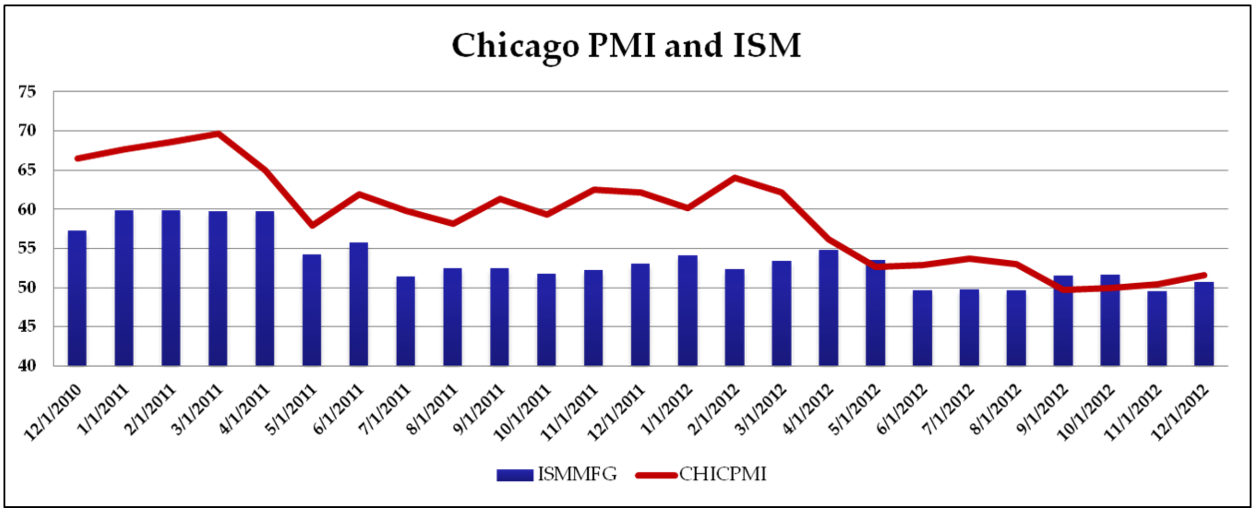
More fundamentally, the Obama administration has yet to articulate it's a long-term fiscal plan in the context of its economic objectives. Economists seem to agree on a number of issues:

- The country needs to stabilize its public debt to GDP ratio, but can only do so through faster economic growth
- Non-defense/discretionary spending has already suffered deep cuts
- Federal revenues have fallen from about 19% of GDP in the pre-crisis period to about 17% in the post-crisis one. This level is not sufficient to sustain the long-term growth of non-discretionary/non-defense spending, and achieving a more balanced long-term fiscal posture will require both a reform of the entitlement programs as well as new revenues
- Reducing the deficit through austerity measures is  a non-starter, and can in fact have the reverse effect of pushing the country in a recessionary spiral

***Economic Resilience:*** Despite the economic policy uncertainties and the devastation caused by Hurricane Sandy, the US economy has held up remarkably well in the past few months, with most economic indicators staying in or returning to positive territory. While consumer confidence indicators sank in December on concerns about the fiscal cliff, disposable income and personal consumption expenditures rose by respectively 0.6% and 0.4% month-on-month (m/m) in November, while retail sales increased by 0.3% (m/m). However, the Holiday shopping season proved to be a disappointment with same-store sales rising by 3.3% year-on-year (y/y) as compared to 4.2% in December 2011. Both forward-looking and activity indicators showed an industrial and manufacturing sector on the mend. November industrial production rose by 1.1% m/m. The Market PMI-Manufacturing rose from 52.8 at end-November to 54 at end-December, the ISM-Manufacturing rose over 50 during the same time period, and the Chicago PMI (which is broader than manufacturing) increased to 51.6. The Empire

State index suffered from the effects of Sandy, remaining in negative territory, but the Philadelphia Fed index switched from minus 10.7 to plus 8.1. The December ISM non-manufacturing (services) index beat market expectations and rose to 56.1 from 54.1 in November. Oil prices (West Texas Intermediate) edged over the $90/barrel (bbl) level on 12/26 for the first time in five weeks, ending the month at around $92/bbl.

**Fig. 1: <u>Chicago PMI and ISM-Mfg</u>**

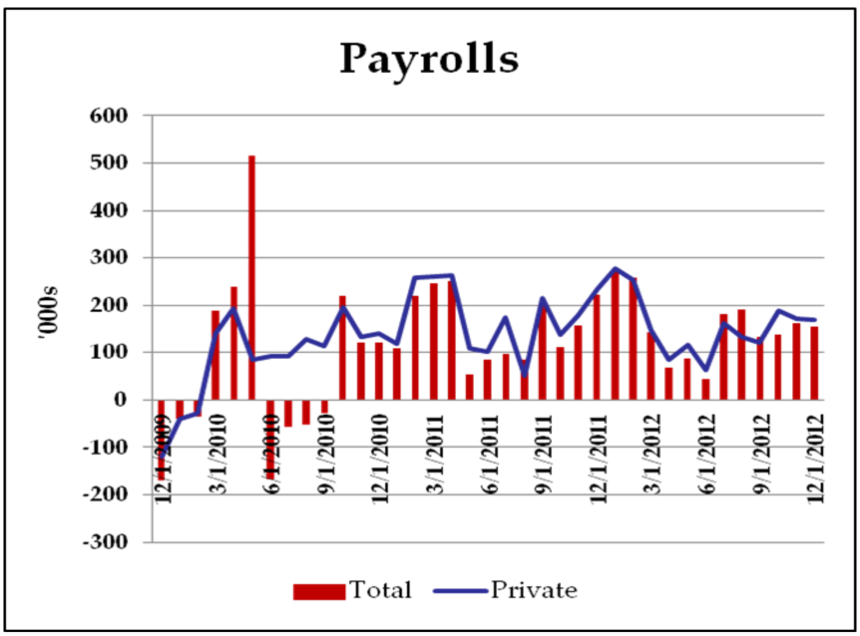



***Housing Revival Solidifies:*** The housing market continues to improve at a steady pace. Housing starts and new home sales remained steady at respectively 377,000 and 861,000 in November, while existing home sales exceeded an annualized pace of 5 million for the first time since July 2007. Overall, in the past 24 months, housing starts increased by 59%, new home sales by 30% and existing home sales by 26%. The Case-Shiller housing prices index was up for the 8th consecutive month in October—house prices rose by 4.3% in the past 12 months. Residential investment rose by 14% in 2012, the highest level since the end of 2008, and is expected to increase by 20% in 2013. The real estate rebound is likely to continue, and even accelerate in 2013. On the demand side, there is considerable pent-up demand for housing as household formation is accelerating (about 1 million in the last year). In addition, demand by real estate investors remains strong. On the supply side, several years of below-trend new construction and the removal of foreclosed and/or aging properties from the market have resulted in housing inventory falling below the five month level. The sustained improvement in labor markets and household income and improved availability of financing, should further strengthen these positive trends.

***Labor Markets Dull but Steady:*** High frequency labor market data support the view of a steady pace of improvement in the employment situation. First time jobless claims have been distorted in the past two months by Hurricane Sandy, and showed a slight increase to 372,000 in the last week of the year in the context of a more significant long-term improvement. Non-farm payrolls increased by 155,000 in December (private payrolls rose by 168,000), with an upward revision of +14,000 for the previous two months. This brought the average payroll increases to 176,000 for 4Q12, up from respectively 152,000 in 3Q12 and 106,000 in 2Q12. The goods producing sector employment showed a strong rebound in December, with 59,000 new jobs added. Manufacturing employment expanded for the second month in a row (+10,000) and construction payrolls were up 10,000. The services sector generated 168,000 jobs. The rate of job market participation was steady, and unemployment remained at 7.8%. Overall, jobs creation has averaged 152,000/month in 2012, the same as 2011, showing a steady pace of expansion, albeit one which needs to accelerate to significantly dent the high level of unemployment.

In addition, weekly hours worked increased by 0.1 hours and hourly wages rose by 0.3%. In combination, these numbers show an increase in the earnings proxy of 3.5% (annualized) in 4Q12 from 2.8% in 2Q12.

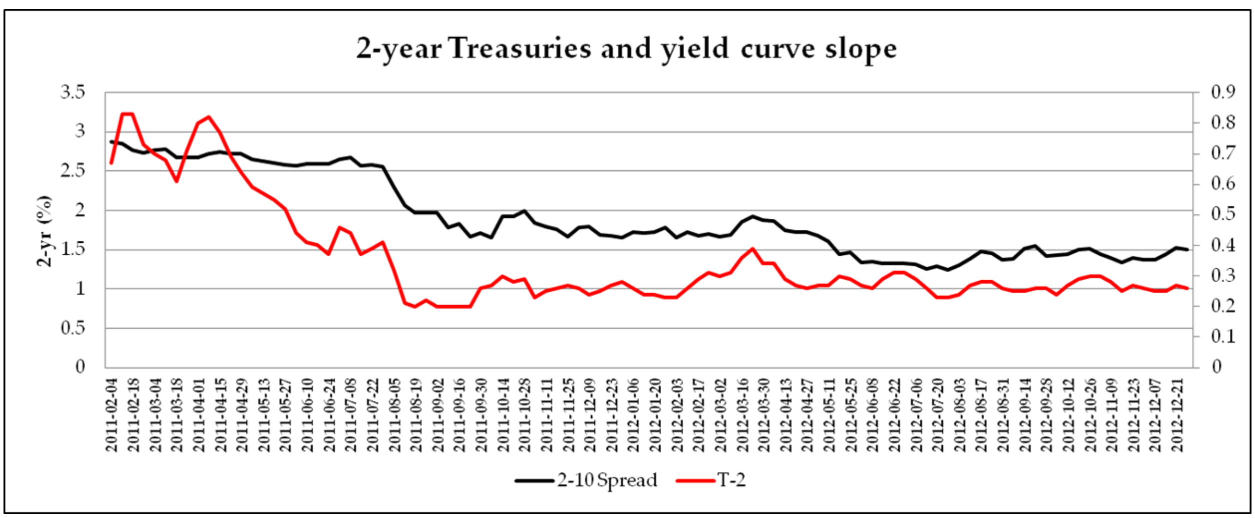
**Fig. 2:** <u>Payrolls</u>



***Long-term Labor Market Trends:*** In assessing the payrolls report (and by extension macro-economic performance), we must incorporate secular trends in the labor market coming from the aging of the population, trends that emerged over a decade ago. In the fifty years that followed World War Two, the United States benefitted from rapid growth in its labor force. This expansion of the labor force in the post WW-II era came as a result of demographic forces (baby boomers) and rising participation rates as more women entered the labor force. From 1948-2001, the growing labor force contributed 1.7% annually to output growth (the rest coming from productivity increases). However, as a result of the aging of the population in the past two decades, these trends have reversed themselves, and in the past decade, the contribution of labor force increases to output growth has fallen to an average of 0.5% per year. As mentioned before, this change is due to the shift in demographic forces, in particular the decline of the share of the 16-54 years cohort and the rise of the 55-64 years one, the latter now accounting for 25% of the labor force. This has impacted the participation rate, which has fallen from a peak of 67.3% in 2000 to 63.6% today (a trend that has been accelerated by the Great Recession).

This means that the rate of payroll growth needed to maintain the unemployment constant has fallen from about 150,000/month earlier in 2000s' to about 100,000 today, and that is why we saw unemployment drop by 2.2% in the past two years with an average job creation of 167,000/month. This trend, of course, is not good news. It means that unless we keep people longer in the labor force (by raising the retirement rate) or increase productivity, we will face a fall in the potential annual output growth rate from 3.5-4% to 2.5-3%.

**Fig. 3: <u>Yield Curve</u>**



***Looking for the Exit:*** The Open Market Committee of the Federal Reserve Bank (FOMC) met on December 12th and took the unprecedented step of benchmarking monetary policy to economic conditions by stating that extraordinary measures will continue until the unemployment rate has fallen to 6.5% (from the end-November 7.7%) or that inflation reached 2.5%. The Fed, which projects economic growth next year to reach 2.3-3.0%, does not expect this point to be reached before 2015. This means that through its quantitative easing program the Fed will continue to purchase longer term Treasury securities at the $45 billion/month level. However, these purchases of longer-term Treasury securities will no longer be funded by the sale of short-term securities, and will go directly into the banking system's reserves. In addition, the Fed will continue to purchase $40 billion/month in mortgage securities.

**Table 2: <u>Federal Reserve Economic Projections</u>**

| (percent) | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|
| GDP growth | 1.7-1.8 | 2.3-3.0 | 3.0-3.5 | 3.0-3.7 |
| Unemployment | 7.8-8.2 | 7.4-7.7 | 6.7-7.3 | 6.0-6.6 |

FOMC: December 2013

Nevertheless, the Fed could be looking at an earlier exit from Quantitative Easing, which seems to have reached the point of diminishing returns. The release of the minutes of the December FOMC meeting revealed some difference of opinion among participants about extending the program, with some arguing that the quantitative easing should be phased out before the end of 2013. In any case, it is likely that the Fed will play a more passive role in the months to come. By the third quarter at the latest, we could be looking for a gradual exit from the extraordinary measures undertaken in the last few years.

***A Mixed Global Picture:*** Global economic performance picked up. The JPMorgan Global All-Industries PMI rose to a 9-month high of 53.7 in December. China seems to have emerged from its industrial production slowdown, with economic growth has settled around 7-8%. The main drags on global growth remain Japan and the eurozone. Nevertheless, even the eurozone ended the year on a more hopeful note, and calamity was avoided. The Greek government was able to push through its economic program, as well as a buyback a portion of its debt at a deep discount. Meanwhile, both Italy and Spain made progress on their economic restructuring. Most importantly, the extraordinary monetary measures taken by the European Central Bank calmed financial markets, allowing a sharp drop in borrowing costs for the crisis-stricken countries. In Europe, there are some hopeful signs that the UK will avoid a triple-dip recession. However, the picture for the eurozone is one of a mild recession in 2012, followed by a flat economy in 2013. Moreover, with the exception of Germany and France, the crisis-stricken economies remain in deep recession.

***Looking Back:*** The main economic themes in 2012 were economic resilience and dull, but steady, growth. We saw three different phases in 2012: relatively strong first quarter dynamics interrupted by a eurozone flare-up; a weakening economy in the second and third quarter with a global manufacturing and business investment pullback and a flagging employment situation; and finally a modest rebound in the fourth quarter, with manufacturing on the mend, and an acceleration of employment growth. The recovery in the fourth quarter was supported by a stronger wealth effect—in part due to the bull market in 2Q12 and 3Q12, as well as clear signs of revival in the real estate. While consumer confidence was eroded at the end of the year by the political deadlock in Washington, ultimately the fiscal cliff issue did little to damage to either the equity markets or the economy.

***Looking Forward:*** At the onset of 2013, there are hopeful signs for the economy:

- As stated earlier in this report, the labor markets show signs of sustained, albeit modest improvement; In combination with improved earnings, this should feed on consumer confidence
- The housing market recovery and strong residential investment should add 0.75% to GDP growth in 2013
- With the resolution of the uncertainty over tax rates, business investment and manufacturing should continue their recovery
- The global backdrop has also improved; In particular, the leadership transition in China is over and President-elect Xi Ping is expected to continue the economic stimulus policies in place
- The US consumer continues to show resilience
- Equity markets have rebounded to new highs after the fiscal cliff vote

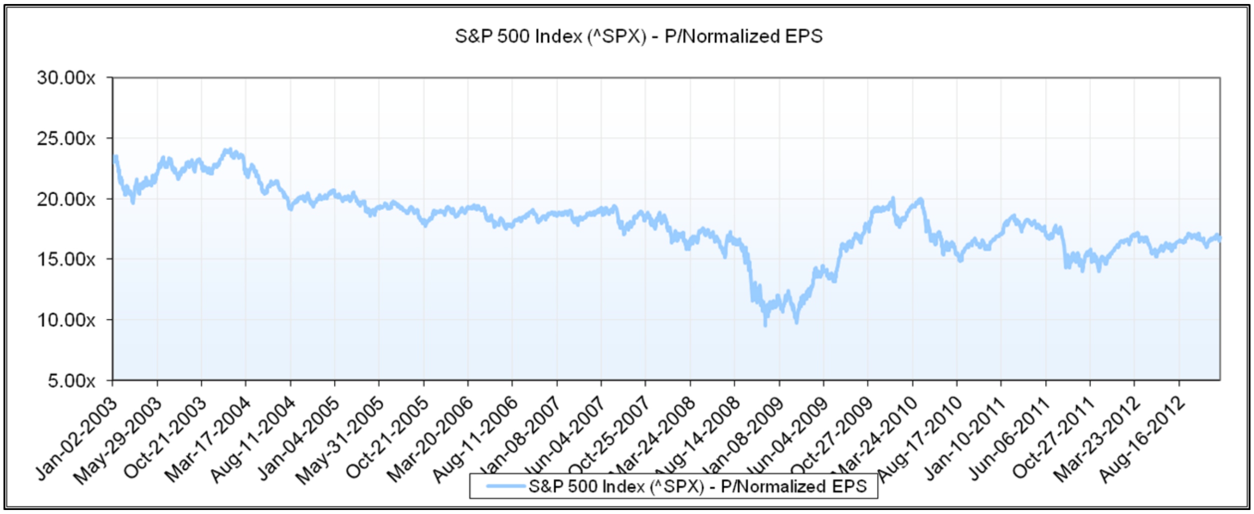
Overall, we expect the private sector to provide a renewed lift to the economy. Monetary policy is steady and accommodative, but fiscal policy is in shambles. Even in the best of cases, we will face significant fiscal tightening of about 1.0-1.5% of GDP (half from the end of the payroll tax cuts, and half from spending cuts). Nevertheless, the economy is in a stronger position today, even private sector dynamism will be offset in part by a front-loaded fiscal drag. Overall, we expect trend growth of 2.0-2.5% in the first half of the year, with an acceleration of output growth in the second half to 2.5-3.0%.

Political risks could undermine this moderate growth scenario. Congress kicked the can down the road, and we are expecting another major political circus surrounding the required increase in the debt ceiling and spending cuts by the end of February. This could lead potentially to a downgrade of the US government's remaining AAA rating (Moody's) and further turmoil in equity markets.

A further damper on longer-term prospects comes from the austerity bias built in fiscal policy at the global level. A recent study by the IMF points to the fact that the simultaneous emphasis on fiscal austerity and debt reduction at the expense of growth in the major economies can inflict damage on long-term trends and build a recessionary bias in these economies.

Other risks to this scenario are unfortunately quite familiar: turmoil in the Middle East and military conflict with Iran; and/or another round of eurozone financial upheavals.

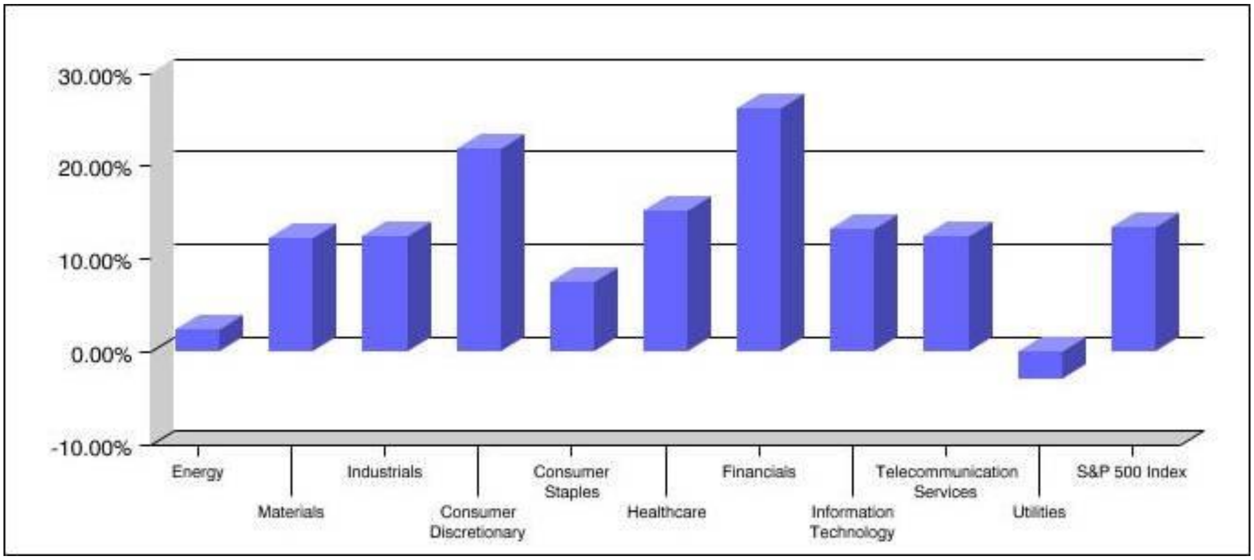
**Fig. 4: <u>S&P500 Price-Earning Ratio</u>**




***Market Highs Mark Volatility:*** December equity market seesawed in December in response to the ups and downs of the cliff negotiations—or lack thereof. The impact of the fiscal cliff debate did somewhat dent the equity markets' 2012 performance. Nevertheless, the markets ended a very strong 2012 on a high note, with the major indices reaching a 3-month high at the January 2nd opening. The S&P500 gained 13.4% in 2012. However, this strong performance marked very strong volatility, and most of the gains were concentrated in the first and third quarters, with a flat fourth quarter. The S&P500 reached a 5-year high of 1,461 on October 4th, then fell to a low of 1,406 on December 7th before ending the year at 1,426. Ultimately, both the S&P500 and the Dow Jones managed to defend their respective levels on 1,400 and 13,000 despite the turbulence. For the year as a whole, we saw a domination of the cyclical sectors over the defensive ones.

The index has been above its 50-day moving average for most of December, indicating a mild bullish trend. The P/E ratio averaged 16.24 for the year, below the pre-crisis average (Jan 2003-Sep 2008) of 18. A rough calculation based on the 4Q12 average for the S&P500 and the pre-crisis P/E indicates that the index could reach 1,500-1,550 over the next few months.

**Fig. 5: <u>12-month S&P500 Sectoral Performance , end 2012</u>**



# December 2012 Economic Data

**Data Releases**

ECONOMIC DATA RELEASES

| December 2012 | Prior | Consensus | Actual | Min | Max |
|---|---|---|---|---|---|
| **Macroeconomy** | | | | | |
| GDP (3Q12, % Annualized) Final revision | 2.7% | 2.8% | 3.1% | 2.6% | 3.0% |
| CPI (m/m) Nov | 0.1% | -0.2% | -0.3% | -0.3% | 0.2% |
| Core CPI (% m/m) Nov | 0.2% | 0.2% | 0.1% | 0.1% | 0.2% |
| **Balance of Payments** | | | | | |
| Exports (% m/m) (Oct) | 3.1% | | -3.6% | | |
| Imports (% m/m) (Oct) | -0.2% | | -2.1% | | |
| Trade Deficit $ billion (Oct) | $40.3 | $42.8 | $42.2 | $41.0 | $44.6 |
| Current Account Deficit ($ billion) (3Q12) | $118.4 | | $107.5 | | |
| **Industrial Production** | | | | | |
| Empire State (Dec) | -5.22 | 0.0 | -8.1 | -7.0 | 8.5 |
| Philadelphia Fed (Dec) | -10.7 | -2.0 | 8.1 | -12.4 | 15.4 |
| ISM-Mfg Nov | 49.5 | 50.5 | 50.7 | 49.3 | 52 |
| Chicago PMI (Dec) | 50.4 | 51.0 | 51.6 | 49.0 | 52.8 |
| Markit PMI Mfg Nov | 52.8 | 54.2 | 54.0 | 52.8 | 54.5 |
| Industrial Production (% m/m) Nov | -0.7% | 0.3% | 1.1% | 0.4% | 0.9% |
| Durable Goods (m/m) Nov | 1.1% | 0.5% | 0.7% | -1.5% | 2.2% |
| Durable Goods, ex transp (m/m) | 1.9% | 0.2% | 1.6% | -1.0% | 0.7% |
| Factory Orders (m/m) Nov | 0.8% | 0.3% | 0.0% | 0.4% | 0.8% |
| **Services** | | | | | |
| ISM non-mfg Sep | 54.7 | 54.5 | 56.1 | 53.0 | 56.0 |
| **Consumer Spending** | | | | | |
| Retail Sales (% m/m) Nov | -0.3% | 0.6% | 0.3% | 0.2% | 2.0% |
| UMich Consumer Sentiment (2d half Dec) | 74.5 | 75.0 | 72.9 | 64.9 | 82.0 |
| ConfBd Consumer Confidence (Dec) | 71.5 | 70.0 | 65.1 | 64.8 | 79.0 |
| Personal Income (m/m) Nov | 0.1% | 0.3% | 0.6% | -0.1% | 0.7% |
| Consumer Spending (m/m) Nov | -0.1% | 0.4% | 0.4% | 0.2% | 0.7% |
| **Housing Market** | | | | | |
| Housing Starts ('000) Nov | 888 | 865 | 861 | 840 | 940 |
| New Home Sale ('000) Nov | 361 | 375 | 377 | 360 | 390 |
| Existing Home Sales (MM) Nov | 4.76 | 4.9 | 5.04 | 4.6 | 4.96 |
| Case Shiller-20 (m/m) SA Oct | 0.4% | 0.5% | 0.7% | 0.3% | 0.8% |
| Case Shiller-20(y/y) Oct | 3.0% | 4.1% | 4.3% | | |
| **Employment** | | | | | |
| First Time Claims ('000) (1st week Dec) | 370 | | | | |
| Non-Farm Payroll (Nov) | 161,000 | 155,000 | 155,000 | 125,000 | 225,000 |
| o/w Private Sector (Nov) | 171,000 | 157,000 | 168,000 | 130,000 | 220,000 |

*Dr. Pakravan has been a senior economic strategist in global financial markets for 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.*