Economic Outlook

Fourth Quarter 2012

Markets Climb a Cliff of Worry

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- Despite all the political and economic uncertainties in the world, financial assets registered robust gains in 2012.
- We expect 2013 to be characterized by improved global economic growth, less financial-market volatility in Europe and some calming of the political waters in the U.S. and elsewhere.
- While this should be good news for equity markets, we strongly believe that the 30-year secular bull market in bonds is drawing to a close.

If the past year is a good example of the "New Normal," most investors wouldn't complain if 2013 turned out to be a carbon copy. Despite all the political and economic uncertainties in the world, financial assets registered robust gains in 2012. In the U.S., large-cap equities, as measured by the S&P 500, climbed some 16% (dividends included). Other developed-country stock markets caught up to and surpassed the performance in the U.S. during the second half of the year, as reflected by a 17% gain in the MSCI World Total Return Index. Emerging markets enjoyed an even bigger comeback in recent months, with MSCI Emerging Markets Index ending the year with a 17% total return.

The gains in equities eclipsed the total returns of the U.S. investment-grade bond market (the Barclays Aggregate Bond Index returned 4.2%), although global corporate bonds (+13% for the Barclays Global Aggregate Corporate Bond Total Return Index), high yield (+16% for the Barclays US Aggregate Credit High Yield Corporate Bond Total Return Index) and emerging-market debt (+18% for the Barclays Emerging Markets (USD) Total Return Index) provided equity-like returns as yield-hungry investors piled into those asset classes at a near-record clip.

Can risky assets repeat their performance of the past year? We think that can certainly be the case for equities, thanks to improving economic fundamentals, the aggressive provision of central-bank liquidity, and reasonable – even attractive – valuations. Fixed-income assets, on the other hand, could lag as the world economy continues to trudge along the road of rehabilitation, although higher-yielding fixed-income plays should continue to perform better than their investment-grade counterparts. That said, one can always count on a few bumps (or should we say cliffs?) along the way.

The U.S.: A Nation of Cliff Dwellers

A major pre-occupation for the worrier class in recent months has been the so-called fiscal cliff, the combination of tax increases and spending cuts that threaten to push the U.S. economy into recession in the absence of a timely compromise in Washington. The election results in November practically guaranteed a very difficult negotiation between the opposing parties. Buoyed by his re-election and the unexpected addition of two Democratic Senate seats, President Obama felt he had a strong hand in his dealings with the Republicans. However, it's important to remember that America's Founding Fathers made it a point to create various levels of checks and balances aimed at throwing sand into the gears of government. Although Republicans lost eight seats in the House of Representatives last November, those losses follow a 64-seat gain in 2010. Even at reduced numbers, House Republicans still enjoy their second-biggest majority since 1947-48 and remain firmly in control of that side of the Legislative branch.

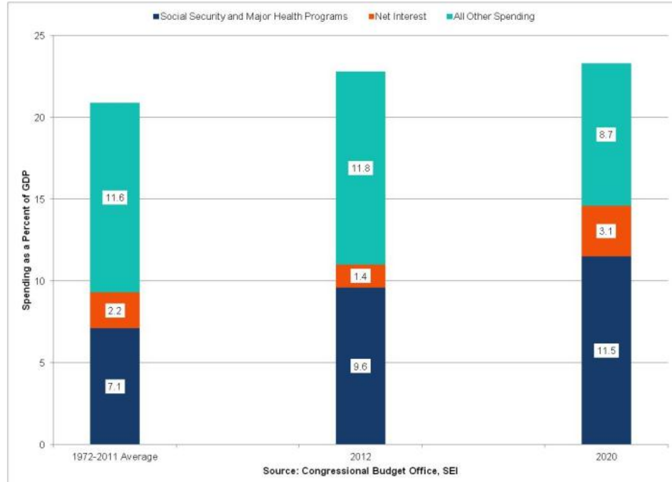
Undoubtedly, the election results have made it clear to both parties that neither side will be able to run over the other. Republicans admitted the need to raise revenues early on in the process and, in mid-December, Mr. Boehner officially put an increase in the marginal tax rates (albeit, applied only to millionaires) on the table. President Obama also showed some flexibility, backing off a long-held proposal to increase tax rates on all households that earn more than $250,000 upon the expiration of the Bush-era tax cuts. As it turns out, a compromise was reached, with tax rates untouched for individuals with incomes of less than $400,000 and families with incomes of less than $450,000. This agreement was reached in the Senate with strong bipartisan support, then passed by the House where it enjoyed more Democratic than Republican support.

Other taxes will still go up for "The Two Percent." The Medicare payroll tax on wage and salary income above $200,000 for individuals and $250,000 for families is scheduled to increase by 0.9% as part of the Obama healthcare reforms. In addition, the personal exemption phase-out and the limit on itemized deductions would be reinstated for incomes above $250,000 for single filers and $300,000 for families. Tax rates on investment income, meanwhile, look set to rise to 20% on capital gains and qualified dividend income. When you throw in an additional 3.8% ObamaCare-related tax on investment income, the total tax increase on capital gains and dividend income will be shockingly large compared to the 15% top tax rate that has been in place since 2003.

The fight over marginal tax cuts has overshadowed other aspects of the cliff. Social Security-related payroll taxes, for example, will return to their previous rate. The annual AMT and doctors' "fixes," and a renewal of extended unemployment benefits are also part of the agreement. The estate tax also will increase, but only to 40%, and the threshold at which the tax kicks in remains unchanged. The implementation of across-the-board spending cuts affecting defense and other non-discretionary programs (the "sequester") also will be delayed for two months.

Compromise on taxes has been tough enough. Agreement on cost savings has been impossible. Entitlement reform is now the larger sticking point. Modifying the Consumer Price Index formula to calculate cost-of-living increases for benefits and tax brackets had been proposed in an earlier phase of the negotiations, but has been taken off the table by the President for now. In any event, much more will need to be done to satisfy the conservatives in the House of Representatives. Without significant reforms, Federal government outlays for Social Security and health care are projected to rise to 11.5% of gross domestic product (GDP) in 2020, up from 9.6% in 2012 and a forty-year average of 7.1%, according to the Congressional Budget Office. Exhibit1 highlights the data. Unless growth in these programs is contained, the Federal government will continue to run large deficits of 4% to 5% of GDP even in good economic times. The debt will continue to grow as a share of the economy, crowding out investment and other private-sector activity.

Exhibit 1: Pensions and Medical Care Will Drive Growth in Government



The politicians have done their best to avoid making tough decisions on entitlements for the past two decades. Now that the Baby Boomers are retiring, the pressure on the government's finances cannot be ignored any longer. Changing the cost-of-living adjustment is a baby step in this regard; we expect this change to be one of the features of any near-term compromise over entitlements spending. Changing the eligibility age for Medicare to age 67 from 65 is a more radical step that we think will occur eventually.

In our previous Quarterly Outlook, we highlighted the loss of competitiveness sustained by the periphery countries of Europe, as detailed by the World Economic Forum's (WEF) Global Competitiveness Index. What we did not emphasize at that time was the deterioration in competeveness recorded by the United States in recent years. The nation's ranking has slipped from #1 as recently as 2008-09 to #7 in the latest survey. Exhibit 2 highlights which "pillars of growth" are behind the drop. By far and away, the most dramatic deterioration can be found in the Macroeconomic Environment, with the U.S. now ranking 111 out of 144 countries. In the WEF's methodology, this is the result of the government's huge deficit shortfall, the high debt-to-GDP ratio and the country's low national saving rate. While one can argue about inputs and the methodology of the WEF's country rankings, the issue of fiscal sustainability is one of pressing importance. Europe has been embroiled in rationalizing its welfare state in recent years. After much procrastination, the U.S. is on the verge of taking its first real steps down that same road.

Exhibit 2: Pilloried by the Macroeconomic Pillar

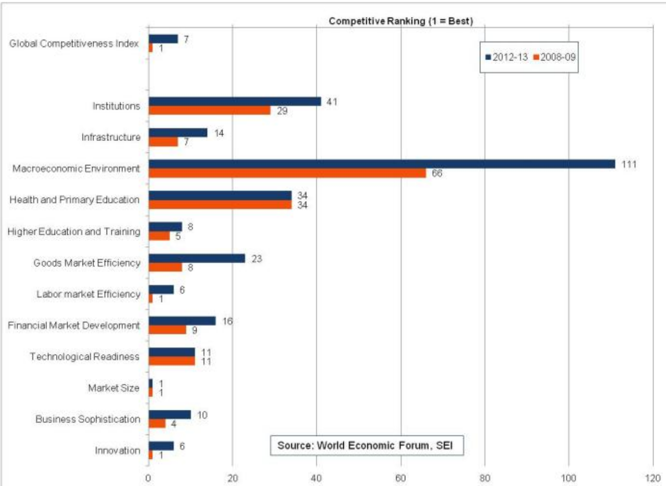
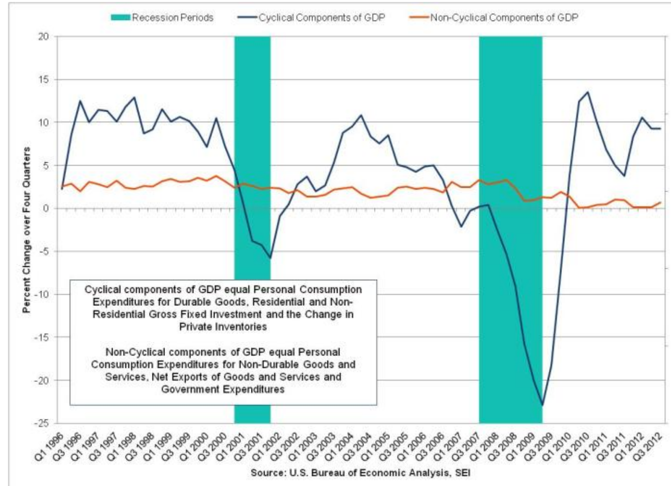


Exhibit 3: Pent-Up Demand Gets Satisfied



What, Me Worry?

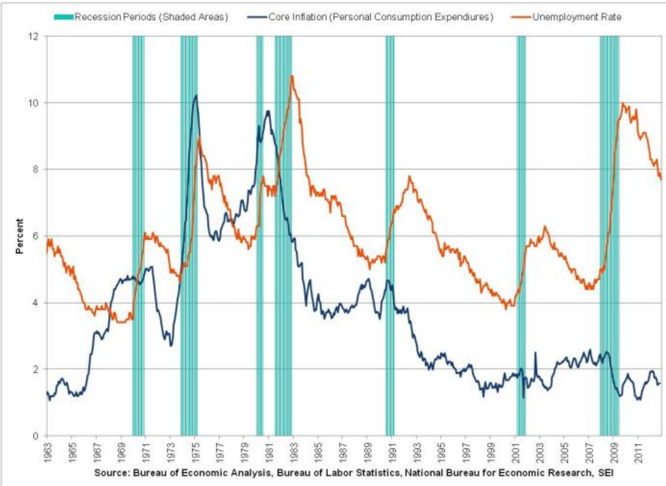
The biggest surprise of the past two months is not the political tussle over taxes and spending, however. It has been the indifference of investors and consumers at the prospect of going over the cliff. Following a brief dip in U.S. equity prices heading into the final weeks of the elections and a further drop immediately following the results, the U.S. stock market rallied back to almost a four-year high. The economy has also performed well. Despite the disruption caused by Superstorm Sandy on the East Coast, consumer spending continues to grow at a modest but steady pace and consumer confidence remains well above previous lows, even though a significant drop took place in December on rising cliff concerns.

Rather than being oblivious to what's going on in Washington, we believe households are being rational in thinking that they ultimately are not going to take much of a hit beyond the increase in Social Security payroll taxes. People recognize that their financial condition is much improved and they can see that the housing market is on the mend. As Exhibit 3 clearly shows, the cyclical portions of the economy have enjoyed healthy growth, adjusted for inflation, of more than 9% in the past year. This includes spending on durable goods, housing and business investment. It's the non-cyclical side of the economy that continues to drag, especially spending on services and government-related activities.

Investor confidence, meanwhile, has been bolstered by the Fed's aggressively expansive monetary policy actions. As we expected three months ago, the Fed recently announced that it will now purchase Treasury bonds outright as part of its quantitative easing efforts upon the expiration of Operation Twist. In addition, the U.S. central bank has made known its intention to support the economy in a very forceful manner until the unemployment rate drops below 6.5%, at least until the core inflation rate (excluding food and energy) rises toward 2.5%. Exhibit 4 provides a 50-year view of both economic measures. Obviously, Fed Chairman Ben Bernanke and his colleagues are betting on inflation remaining anchored near the 2% mark, as has been the case for the past 20 years. This is probably a safe bet in the near term. Gains in employee compensation remain minimal, and unit labor costs – the difference between compensation and productivity growth – have declined 1.9% over the past four quarters. But we should remain cognizant of the 1970s experience – once inflation gets embedded in people's expectations and decision making, we could end up with the worst of both worlds.

While overall growth might be slow and unemployment is still too high, there is a general sense that the U.S. is still moving in the right direction. If government fiscal policy reforms can be put into place sooner rather than later, the economy and risk assets should continue to respond in a mostly positive fashion. The fiscal fight will continue to be grueling, however, and will be associated with another ugly showdown over the debt ceiling in the weeks ahead.

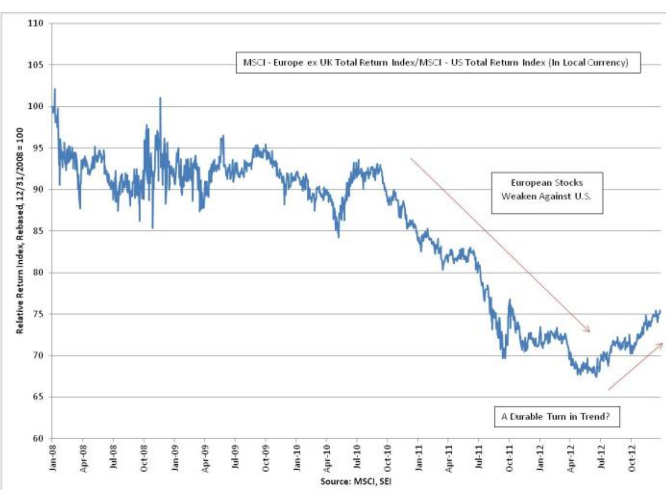
Exhibit 4: What the Fed Is Watching



Europe: Progress Comes at a Cost

While the U.S. has been absorbed in Presidential politics and fiscal-cliff negotiations for the past several months, Europe has enjoyed a resurgence of investor interest. Equity and fixed-income markets have rallied strongly since mid-year, as confidence grows that the eurozone will stay intact and that policymakers are making progress toward fiscal union (Exhibit 5). Among the things that have gone right: (1) a favorable election result last June in Greece, culminating in a new bail-out package; (2) steps toward a more unified banking system giving the European Central Bank oversight authority over the region's biggest banks; and (3) signs that the periphery countries are succeeding in lowering their labor costs and narrowing their budget gaps.

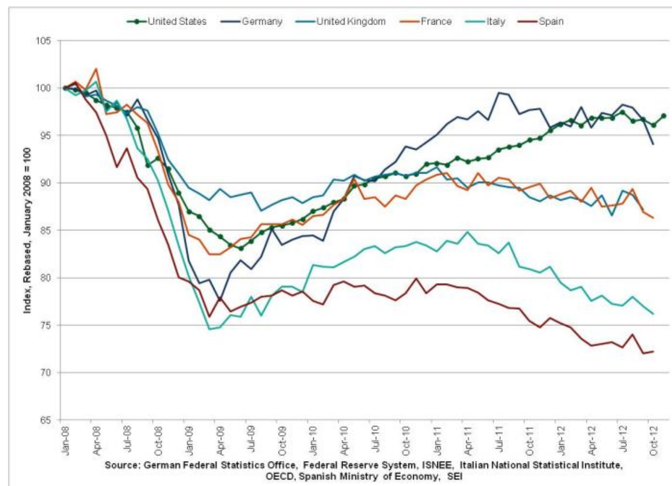
Exhibit 5: European Stocks on the Comeback Trail



The challenges facing the region remain daunting, however. The periphery countries remain stuck in deep recession and growth in the core countries of Germany and France is threatening to stall. Outside the eurozone, the United Kingdom's economy also continues to sputter..

Industrial output has weakened considerably throughout Europe in contrast to continued growth in the U.S, as shown in Exhibit 6. The eurozone unemployment rate also hit another record high in November, rising to 11.7%. Unemployment in Spain and Greece has reached horrendous levels of more than 25%, with youth unemployment approaching an incredible 60%. The year-over-year change in overall employment is down a less-dramatic 0.6% in the eurozone over this period, but hiring surveys are pointing to further declines.

Exhibit 6: No End to Europe's Slump



The poor labor markets in the periphery countries have resulted in reduced wages and some closing of the competitiveness gap versus the European core. However, labor market reforms that would make it easier to hire and fire have been much harder to push through. It's hard to believe that youth unemployment could get worse, but it probably will.

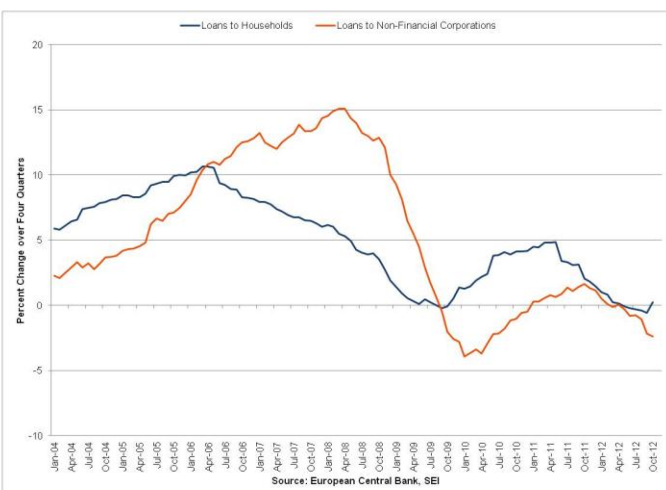
We've been surprised by the magnitude of the rally in European markets. It helps, of course, that European central Bank President Mario Draghi stands ready "to do whatever it takes" to maintain the economic and financial integrity of the eurozone. We also understand that investors are relieved to see German officials collaborating with other eurozone countries instead of scolding them for a lack of discipline. Maybe it's just a matter that asset prices (especially in the periphery) had gotten to a point where a break-up of the eurozone was actually priced in. As the danger passed, asset prices were reset higher.

In any event, we remain eurosceptics when looking out the next 12 months. We believe France is emblematic of the potential downside that continues to exist. When a country as big as France allows its industry minister to say, "Nationalizing is a very modern step to take" during a battle with ArcelorMittal to keep a loss-making steel plant open to save 629 jobs, you might think that such an anti-business attitude would cause investors to flee. On the contrary, French stocks are near their highs for the year, with the MSCI price-only index up 15%. There's been very little sign of capital flight – yet.

We also view France as a leveraged play on the periphery. It has the largest domestic bank exposure to the European periphery of any creditor country, amounting to 20% of GDP. Loans extended to the Italian government and to private-sector borrowers account for some 60% of total loans outstanding to periphery countries. A renewed flare-up of the debt crisis could be a catalyst for a sharp correction. That potential flare-up, however, seems to be the last thing on investors' minds at the moment: Italian 10-year government bond yields have fallen below 4.5%, their lowest level in more than 18 months, even though Mario Monti, the country's technocratic Prime Minister, has resigned.

In summary, European financial markets have done much better than expected, but the economies have performed about as badly as we thought they would. Although investors are showing a new-found confidence, we continue seeing additional difficulties ahead. In particular, the European banking system remains in poor shape. Exhibit 7 underscores the lack of credit creation in the eurozone. Until the banking system is on a sounder footing, the region will continue to suffer economically.

Exhibit 7: No Credit Where Credit Is Due



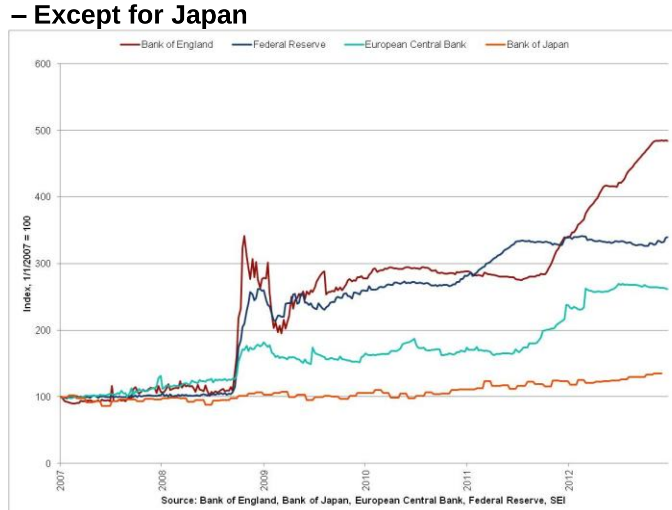
A New Day in Japan?

It's been a long time since investors have been optimistic about Japan. The equity market has been a poor performer for much of the past two decades, languishing about 70% off its 1989 peak. Like much of Europe, the country has suffered a prolonged period of economic stagnation and is in the midst of another recession. Consumer prices are still falling despite the Bank of Japan's quantitative-easing efforts.

Recent elections, however, have brought the Liberal Democratic Party back into power, with a strong mandate to force through reflationary policies. Shinzo Abe, the new Prime Minister (the seventh PM in seven years, one of whom was Mr. Abe himself) was quite vocal in his criticism of the Bank of Japan and its cautious approach. In April, the Prime Minister will replace the current BOJ Governor with someone who will have a more dovish, Bernanke-like bent.

In the meantime, the BOJ is already bowing to the pressure to pursue an easier course. On December 20, the central bank announced that it will increase its Asset Purchase Program and provide additional liquidity through its Stimulating Bank Lending Facility. Relative to GDP, the BOJ's quantitative easing program will be even more aggressive than the Fed's is projected to be in 2013. Exhibit 8 shows that the BOJ has been the least aggressive of the major central banks since 2008 in expanding its balance sheet. This is about to change.

Exhibit 8: Bulging Balance Sheets – Except for Japan



Investors have taken notice: The U.S. dollar is trading at a 29-month high against the yen. Japanese stock prices have risen 15% since mid-November. Could this be the start of something big? Only time will tell. Although the recent reversal has been stunning, Exhibit 9 shows that there have been several false starts since 2009 in both the equity market and the currency.

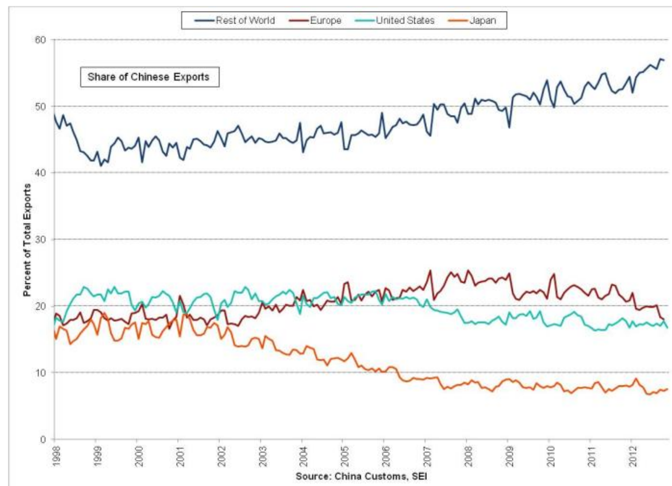
Exhibit 9: Land of the Rising Stock Market?

Nonetheless, we're beginning to think that this time, it's different. The 23-year secular bear has left the Japanese equity market as one of the least expensive in the world, as measured by price-to-book, as shown in Exhibit 10. Meanwhile, Japanese bonds are the lowest-yielding in the world. There certainly are good reasons for these extremes in value. The country's awful economic performance over the past 20-plus years, one of the worst demographic profiles in the world, and a gross debt-to-GDP ratio of more than 200% provide reason for pause. But the promise of a much weaker yen, a still-strong export market to the U.S. and an eventual lessening in tensions with China over the Senkaku/Diaoyue Islands could be the catalysts for sustained improvement in equity market performance – and, perhaps the start of a bear market in Japanese fixed income.

Exhibit 10: Japan's Market is Priced Below Book Value

China also seems to be turning a corner, following months of economic and political uncertainty. Industrial production reaccelerated a bit during the fourth quarter, aided by another round of infrastructure expenditure. Other measures of industrial health, such as electricity production, railway freight traffic and the manufacturing purchasing-managers index, also registered improvement. Although the share of merchandise exports to Europe is falling sharply, the share of total exports to the rest of the world continues to post strong increases, as Exhibit 11 shows. We expect developing-country demand will remain the chief driver behind China's export growth, although a modest rebound in goods shipped to the U.S. also is likely in 2013.

Exhibit 11: China Makes, the Rest of the World Takes



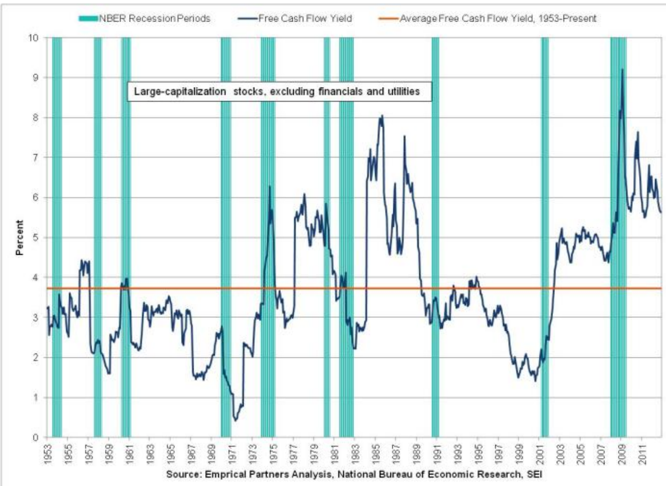
The big story, however, is the political one. Xi Jinping, China's new President, has signaled his willingness to pursue further market-oriented reforms by his symbolic trip to the Shenzhen Special Economic Zone in December. This visit echoed Deng Xiaoping's trip in 1992. Even before the new leadership is fully installed in office, a more energetic management style has emerged.

Our Investment Portfolios

If one can look beyond the partisan battles over the budget in Washington – admittedly, a hard thing to do as the focus shifts toward reforming entitlement spending and raising the debt ceiling – there is reason to be optimistic that 2013 will be characterized by improved global economic growth, less financial-market volatility in Europe, and some calming of the political waters in the U.S. and elsewhere.

Although the U.S. budget fight is far from over, it is our intention to take a more aggressive, pro-cyclical stance in favor of equities. The valuation of global equity markets is still quite reasonable, even though profit growth has slowed. In the U.S., for example, Exhibit 12 shows that free cash flow yields remain well above the historical average of 3.7%. At the stock market's low in September 2011, free cash flow yields were only a percentage point higher than they are now. This is an exploitable theme throughout much of the world as corporations focus on bolstering their balance sheets instead of growth for growth's sake. Relative to bonds, the stock market remains very attractive. Or, to put it more accurately, fixed-income markets are much more expensive than stocks.

Exhibit 12: Go with the Cash Flow



In our view, safe-haven sovereign debt and investment-grade fixed-income assets hold little appeal as total-return vehicles. The concerted efforts of central banks to keep interest rates near the zero boundary may limit the near-term danger of a big reversal in yields and associated drop in bond prices, but we strongly believe that the 30-year secular bull market in bonds is drawing to a close. Whether a new global bear market in bonds begins this year or next, or the year after, today's bond investors are not being paid for the risks they are taking.

Relative-value opportunities still exist in emerging-market debt and in high yield. But, even in these areas, spreads have narrowed considerably versus Treasurys and other investment-grade alternatives. Exhibit 13 highlights the change. It would be surprising if the higher-yielding plays in fixed income replicate their strong performance of the past year. The record flows into these assets over the past two years also suggest that there are fewer opportunities to exploit. Although the fundamentals remain sound, returns should be limited mostly to the mid-single-digit yields available on these assets. If credit spreads tighten further in 2013, we would bet it will be the result of Treasury and other safe-haven sovereign yields rising faster than those on their credit counterparts.

Exhibit 13: Sending Out an OAS

Regionally, we still have our doubts about Europe. Although we have been neutrally positioned in European equities and fixed income versus strategic weights in recent months, we have expressed our long-standing negative view on Europe through a short euro position. This bet paid off nicely earlier this year, but has been something of a pain trade since ECB President Mario Draghi's "whatever it takes" comments in late July. At 1.32 to the dollar, we find it hard to believe that there is a great deal of appreciation potential in the euro. On a purchasing-power-parity basis, the currency should be trading closer to $1.20. As Europe continues to struggle economically, we expect the European Central Bank to adopt policies that will serve to weaken the euro against the dollar. A flare-up of the debt crisis would also serve as a catalyst for a lower euro.

Finally, we are intrigued by the developments in China and Japan. These markets have been out of favor, but are now catching a strong bid. Politics are pushing both countries to adopt pro-growth economic and monetary policies. A stronger East Asian regional economy would have a positive global impact too.

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