2012 Annual Economic Commentary

"Say what you will about Congress, but it has created jobs for people who would be unfit to work anywhere else"

Andy Borowitz

Whatever happened to the Grand Bargain? Was there truly hope that our leaders might deliver short term revenue enhancing measures that boost job creation and stimulate growth via immediate infrastructure stimulus? Might that be combined with medium-term fiscal reforms providing a credible deficit reduction plan?

Politicians and the media fueled concerns over a binary outcome of a "Fiscal Cliff" and the economic impact (immediate recession) that an estimated $607B of tax increases and spending cuts would surely have on an economy finally showing some healing in the housing sector and on consumer balance sheets. Such a sigh of relief can be the only logical explanation for an immediate two day market rally in excess of 4% after an agreement (Taxpayer Relief Act) that can only be categorized as a temporary Band Aid. This appeared to be a consistent theme in 2012 as global markets seemingly danced around macro landmines generating excellent returns over virtually all indices.

The U.S. entered 2012 on a modest upswing following a strong 4Q 2011 Gross Domestic Product increase of 4.1%. Despite this, the signposts of decelerating corporate profits growth domestically and material concerns of a potential Eurozone currency crisis and collateral contagion lowered market expectations. A discernible slowdown and fear of a hard landing in China along with the potential for a divisive Presidential election and looming fiscal headwinds (expiration of the Bush tax cuts and other stimulus measures) added to this toxic cocktail.

We entered the year favoring domestic equities, though pointing out that we found strong long term value in the pricing of developed international markets. However, we felt the acute nature of some of these outlier risks warranted a defensive posture. While accurately anticipating the economic outcomes and risks, we may have underestimated the markets continued comfort with the support and largesse of global central banks. Strong growth did not materialize but increased optimism (in the form of expanding price/earnings multiples) did and the markets enjoyed very generous returns. For the full year, the S&P 500 returned 16.0% with the MSCI EAFE (International Developed) and MSCI Emerging Markets indices generating gains of 17.9% and 18.6% respectively. Virtually all markets were in a range of 16%-18% gains. Our continued constructive (but contrary) position on fixed income also generated very strong returns with the Barclay's US Aggregate (Long) index and Barclays Municipal Bond index realizing 12.8% and 6.8% gains respectively.

Though the fat tail risks of some of these global and domestic outcomes may now be muted (or at least deferred), the issues underlying them have still not been effectively addressed and a market exhale should not be interpreted as an all clear sign. We see this in the positive market reaction domestically as we "averted" the fiscal cliff. We have long characterized this global environment as a post financial crisis recovery. Historic periods such as this take years of deleveraging and debt reduction before consistent growth may resume again. Perhaps the disconnect between market reaction and underlying fundamentals is not identifying this as a fiscal crisis rather than a fiscal cliff and understanding a little more objectively as to how we got here.

Federal tax receipts as a percentage of GDP held very steady at about 18.3% from 1960 to the late 1990's. By the end of that decade, a strong economy and especially a stock market fed by the "dot-com" boom produced a surge in capital gains taxes allowing the Treasury to use these excess receipts to pay down our debt. Total Federal receipts grew to over 21% of GDP engendering the first budget surplus since the 1950's. Additionally, an often less noted aspect of these Clinton years was the reduction in total Federal spending from 22% of GDP in 1992 to 18% by 2000.

Rather than saving these surpluses for the proverbial "rainy day" (as Keynes would have advocated), both parties campaigned in 2000 on a platform of cutting taxes assuming these levels of receipts could be extrapolated into the future. One "dot-com" bust, one housing bust and two recessions later, tax receipts cratered to 15.4% of GDP, the lowest in 60 years. Our Federal Deficit widened to 10.1% in 2009 as Federal spending grew to 25.5% from aggressive efforts to stimulate the economy during the recession. Despite still historically elevated levels, it is important to note that our fiscal deficit has been falling over the last three years at the fastest rate in post war history (the deficit is now 7%) as spending has declined to 22.7% as of the end of 3Q 2012 according to data from the Urban Institute. We would expect even more positive news on this front in the 4th quarter of 2012 as we experience more unwinding of many of the short term stimulus programs and additional military spending declines. This should also combine with what should be higher tax receipts from investors that accelerated capital gains realizations in anticipation of the tax increases.

While we are very concerned about our long term fiscal sustainability, we are mindful (as has been painfully exhibited in Greece, Spain, etc…) that extreme austerity during periods of slow and contracting growth may not be a viable prescription as it might slow spending and the economy, cut jobs and counter-intuitively increase deficits as revenues decline. However, these deficits cannot be ignored and one must look at the numbers from the Congressional Budget Office (CBO) to better understand the magnitude of these fiscal issues.

The CBO estimates fiscal 2012 Federal revenues at $2.45T and Federal spending to be $3.54T totaling a deficit of about $1.1T (which places the $60B of additional annual tax revenue from the top tax bracket increase in greater context). What we must note is that interest on our debt that is part of that spending figure is currently about $258B. The CBO estimates that interest payments could soar to $1T over the next decade. We have referred in prior commentaries to that "bang" moment described by Carmen Reinhart & Ken Rogoff in *This Time Is Different*, their seminal work on the history of financial crises. *"Highly indebted governments, banks, or corporations can seem to be merrily rolling along for an extended period, when bang – confidence collapses, lenders disappear, and a crisis hits".* While the debt issue may not be an imminent concern, a credible longer term deficit reduction plan is critically needed to avoid hitting that moment where interest rates could soar. The challenge is in balancing these needs within our current anemic recovery.

After the deepest economic downturn since the Great Depression, the U.S. economy has exhibited perhaps the weakest post-recession recovery in history with Gross Domestic Product (GDP) growth of 2.4% in 2010 and 1.8% in 2011. Despite a stronger than expected 3Q 2012 GDP annualizing at a rate of 3.1% (unsustainable inventory builds and government spending accounted for 1.5% of this total), we still expect the full year of 2012 to come in no higher than 2.0%, (with 4Q at 1.5% or less) in line with our original expectations for the full year. So what economic impact can we expect from the Taxpayer Relief Act just announced? Basically, it is no relief at all.

Estimates from Barclays Capital and Nomura estimate the total impact of the tax increases (payroll, income, capital gains, Affordable Care Act and the phase-out of certain exemptions) to be almost $200B on an annual basis or about 1.5% of GDP. This does not include another $110B in sequestered government spending cuts that are still pending. The largest impact will be felt in the first quarter as the payroll tax reverts back to the prior 6.2% level from 4.2% (estimated to be $120B of the total). Due to the method by which GDP is calculated (quarter over quarter and then annualized), we fully expect 1Q GDP to be south of 1% with Disposable Personal Income declining as much as 3%. At a point in time where modest progress has been made in consumer balance sheets and the Real Disposable Personal Income per capita just hit a post-recession high of $32,868 (though still off 5.1% from the May 2008 peak), the impact of a 2% tax increase may have a negative ripple effect.

The U.S. continues in a slow healing, muddle-through economy consistent with a post credit-crisis environment. The slow growth levels noted above for 2010-12 were supported by strong government stimulus that allowed consumers to modestly repair balance sheets by reducing household debt service ratios (the ratio of debt payments to disposable personal income) to levels not enjoyed since 1983. This reduced debt burden in theory might allow consumers to increase consumption to levels consistent with growth in income. As noted above, however, this fiscal stimulus is now moving in reverse. It is just this fiscal drag that continues to frame our growth projections for 2013 GDP around 1.5%.

We noted in our most recent commentary that although we had been critical of Chairman Bernanke's early role in the financial crisis and initial policy actions, we could not disagree with the characterization of Ray Dalio of Bridewater Associates. Mr. Dalio had referred to Mr. Bernanke's policies as a "beautiful deleveraging" combining a delicate balance of austerity, restructuring and monetization in steering the economy from the depths of recession. Indeed, our prior concerns of a higher than consensus risk of recession for 2012 underestimated the aggressiveness of Fed policy. However, we still cannot rule out a mild recession in 2013 and certainly do not ignore the risk of collateral damage due to these policies. That is a future battle.

For now, our lack of a cogent fiscal plan continues to force the Federal Reserve and Ben Bernanke to pull double duty and continue to experiment with different methods of avoiding such a "bang" moment. In December, the Federal Reserve announced that it would more than double the amount of market securities it would purchase in 2013 (to about $1T thus expanding the balance sheet to $4T) to continue to stimulate the economy and keep rates low. Additionally, Bernanke announced an economic target rather than an open-ended time horizon during which this zero interest rate policy would be maintained. By specifically outlining the maintenance of continued asset purchases until the unemployment rate declines significantly to 6.5% (as long as inflation is at or below 2.5%), the Federal Reserve has replaced inflation with employment as the primary mandate, a policy switch that Mohamed El-Erian of PIMCO has referred to as the "reverse Volcker moment".

In addition to maintaining low interest expenses on U.S. debt, other benefits of Fed policy may be argued to be found in strong improvement in corporate balance sheets and margins as low rates have fostered a greater issuance of long term corporate debt than at any time in history. This has additional benefits of lower interest expense, greater spending on capex, increasing stock buybacks and rising dividends. Arguably, the greatest benefit may have been achieved in the stabilization and subsequent move off the bottom in the housing sector, an area many economists are now projecting will lead the recovery.

Housing Starts (Residential Investment) in 2012 increased over 20% from 2011 levels. Though only representing 2.5% of the calculation of GDP, this increase added over 0.5% to overall growth during the year. Existing Home Sales increased to their highest levels since November of 2009 with inventory of homes for sale falling to the lowest level since 2001. In addition, household formation which had held to averages of about 650K for the prior 4 years ballooned to 1.15MM in the 12-month period ending September 30th (though still below the 1.25MM long term average) as pent up demand released. It is estimated by Mark Zandi of Moody's Analytics that each new household formed adds an additional $145K of spending through the economy. How did this turnaround occur and is it sustainable?

We had long postulated that levels of household debt (mostly mortgages) would retard any long term recovery in the housing sector and that principal reduction (and lower rates) would be needed. Initially the Administration resisted this path and feared this would crater the balance sheets of the banks as they absorb huge loan losses on their portfolios. Indeed, just last year, the Federal Reserve Bank of New York had estimated that as many as 1.8MM homes would be taken back by banks during 2012. Yet through October this figure was less than 560K. As a consequence of the $25B National Mortgage Settlement between the banks and the government following the "robo-signing" scandal, banks finally addressed the issues of principal forgiveness. Since March, Bank of America alone has provided over $15B of relief to over 164,000 homeowners. Distressed sales now represent less than 22% of home sales versus over 35% at the start of the year. All of these positives are reflected in an estimate by Case-Shiller and Core Logic of annual home price gains of between 4%-6% (though still more than 30% below the 2005 peak).

While very welcome data, we continue to maintain that it is much too early to extrapolate this recovery into 2013 and beyond as most economists have already entered into their models. The major banks are very close to completing their obligations under the settlement with the government so future relief will be muted. Laure Goodman of Amherst Securities still estimates that over 2.8MM homes with a mortgage have made no payment over the last 12 months and Lender Processing Services (LPS) notes there are still 5.3 MM loans delinquent or in the foreclosure process representing shadow inventory. Importantly, one must note that the actions of the Federal Reserve to suppress interest rates have reduced mortgage rates this year from 4.5% to 3.3%. The impact of this on a buyer who wants to spend only $1,100 per month is the difference between buying a property with a $240K mortgage versus now being able to afford a $280K mortgage. That is a 16% increase while prices only reflect a 4%-6% gain. These do not represent organic and sustainable gains in our opinion (what happens when mortgage rates rise?) and the environment is still quite fragile and critically dependent on job and wage growth.

By undertaking the switch in the primary mandate of the Federal Reserve from a focus upon inflation to employment, Bernanke is tacitly indicating a fear that persistently high unemployment risks becoming embedded in the fabric of our economy. We share these concerns with 4.8MM long term (over 6 months with 3.6MM over 1 year) unemployed and millions more having exited the labor force entirely along with youth unemployment in excess of 17%. Consistent with our expectations, however, there continues to be slow improvement in this area though not enough to effectively reduce the labor slack and move us towards trend growth.

Job growth in 2012 was remarkably consistent with that of 2011 as both years averaged monthly payroll gains of 153K. With declining Labor Force Participation levels (due to both the aging of the population and frustrated job seekers leaving the work force), this managed to reduce the unemployment rate from 8.3% at the start of 2012 to 7.8%. We continue our focus, however, on the quality of the job growth and the importance of wages. We have continued to note that fully 51% of all the jobs created in 2012 were in the low wage sectors of leisure & hospitality, healthcare and social assistance, and retail and temporary jobs. The National Employment Law Project refers to this recovery as the "Minimum Wage Recovery" pointing out that these lower wage occupations represented only 21% of the jobs lost during the recession but almost 57% of those we have recovered. Though the last two reports of the year did show some aggregate wage gains, a trend is not established for more concerning reasons.

Much of this is a major secular shift in the foundation of employment. Whereas once manufacturing jobs were the ticket to a solid, middle-class lifestyle, they are down almost 40% from levels of the late 1970's (were 21% of total payrolls and are now only 9%) despite the U.S. being the leading global manufacturer. Indeed, manufacturing in the U.S. is back to pre-recession levels but with productivity up over 50% in the last two decades, the need is for more technically trained employees as the information technology revolution and globalization has changed the skill sets required. An article by Tom Friedman of the New York Times in November quoted an owner of a sheet metal company who could not find qualified welders. The reason is that the high-volume, low-skill jobs are outsourced overseas and the high-tech jobs remaining require knowledge of design drawings, angles, etc…. These are skill sets of advanced math, science and engineering. More skill, education and training are needed.

Perhaps the most positive global and market development in 2012 occurred in Europe where the aggressive actions of the European Central Bank (ECB) were on full display. Starting in August the ECB established Outright Monetary Transactions (OMT) with the objective of buying sovereign bonds issued with 1-3 year maturities. This effectively lowered the borrowing costs and interest rates for Spain and Italy which have fallen about 250 basis points. The European Stability Mechanism (ESM) provides another €500 billion as a backstop. As important has been Angela Merkel's about face and willingness to finance Greece for the foreseeable future preventing a Greek blowup, exit and potential contagion to the region. In addition in December, the European Union agreed to set in motion the eventual establishment of a new single bank supervisor allowing for the eventual pooling of debts and fiscal transfers within the currency union.

However, the powerful rebound in the 2nd half of 2012 in European indices may be another example of the markets taking a victory lap in the middle of the game. Though there has been some progress in fiscal deficits in the weaker countries, the Eurozone periphery shows no sign of recovery as austerity and reforms are recessionary. This has clearly spread to core countries such as France and even Germany who are currently flirting with recession. Key questions surround how long Merkel and Germany will continue with their support. With Euro Area unemployment at 11.8%, we still foresee a very unstable environment and forecast a continued recession in the Eurozone for 2013. The attractive valuations that we had espoused in mid-2012 have receded some as many of these markets have enjoyed gains in excess of 30% since then.

China's slowdown appears to have stabilized and the fears of a hard landing have abated after two stronger months of economic data points to end the year. Nonetheless, it appears that most of this rebound may be based on greater fiscal stimulus by the new leadership. Softening industrial production (down from almost 12% in March to 10% at year-end) along with muted export growth (less than 3%) does not appear likely to reverse in this global environment. Domestic consumption growth (averaging almost 10% per year in the last decade) will be the focus of the new regime but may have little benefit for foreign companies and investors.

2013 commences with a more optimistic consensus. Most strategists foresee a slowing in the first half as the economy absorbs the biggest impact of the fiscal drag and like clockwork expect a second half rebound. Entering 2012, consensus estimates for S&P 500 earnings were $107 versus $95 the prior year. We were more sanguine and targeted south of $95. While the final number will be higher than our projection at about $98, the slowdown has been apparent. Analysts are now projecting a reacceleration to a range of $107-$112. With revenues flattening and profit margins receding modestly, we see downside risk to the $92-$98 area even without a mild recession. Strategists are also of the view that European economic growth is stabilizing, China is reaccelerating and most of the major risks have been muted.

We remain less optimistic and see the economy downshifting again to near stall speed from the 4Q 2012 through the first half of 2013. We are also concerned how the payroll tax shock impacts not only short term consumer spending but also the fragile consumer psychology. Having been supported by fiscal tailwinds over the last three years, the economy may be running out of steam. Our view is that increased domestic austerity combines with the diminishing impact of Fed Policy and available alternatives to place increased pressure on the organic growth of our economy. We may not be ready to remove the training wheels.

Despite the anticipated slow growth environment, corporate cash flows and dividend policies remain powerful. We have long advocated the benefits of focusing on the high quality companies that continue to generate sufficient cash flows and fund consistent dividend growth. Our portfolios have focused on just such companies long before the financial crisis. In 2012 S&P 500 companies paid out a record $281.5 Billion in dividends up 17% from 2011 and 14% higher than the prior all-time high set in 2008. Though some of this was in the form of special dividends in advance of increased taxes in 2013, we expect 2013 will still be higher.

Fear and greed will long be the most powerful behavioral influences on the markets. Greed will often have the impact of increasing prices to a level whereby future returns are compromised. In contrast, the patient investor recognizes the impact of fear as a long term opportunity as prices are bid down to levels where risk is lower and future returns higher. We find today's environment to be quite unique and warranting caution. Though there appears to be much fear, skepticism and global risk awareness in the minds of the investing public, investor actions are in seeming contrast to this fear.

Global central bank activities continue to have a powerful impact on market prices and may have caused some asset classes to divorce from underlying fundamentals. Investors have come under pressure to migrate to more volatile investments in search of yield and returns as Bernanke has pushed investors to take more risk as the usual alternative of the very safe portfolio generates no return in today's environment. Howard Marks of Oaktree Capital Management has pointed out just this inconsistency brought on by Bernanke's zero interest rate policy with which we concur. Marks notes that, *"while few people are thinking bullish today, many are acting bullish…this pro-risk behavior is having its normal dangerous impact on the markets even in the absence of pro-risk thinking….These people aren't buying because they want to, but because they feel they have to."*