Stepping Back from the Cliff: European Stabilization, Asian Reacceleration, U.S. Debt Ceiling, Sequester Debate, and Recovery in Focus; Short-Term Cautious But Positive Overall on 2013

In early January, politicians in Washington reached a last-minute deal to permanently extend the 2003 tax cuts for over 99% of Americans, patch the AMT, and avert at least the most onerous aspects of the so-called "fiscal cliff." But, as Ian Bremmer, president of Euroasia Group opined, "every silver lining has a dark cloud." While the compromise was much better than no deal, and relatively in-line with, to slightly better than our expectations for the level of fiscal drag in 2013 and the income thresholds for tax increases, including the most closely watched dividend and capital gains rates, it came with multiple shortfalls. Washington is, after all, far from a perfect place, especially in the current politically charged environment. The auspiciously named "Taxpayer Relief Act of 2013" fell short of a grand-bargain, contained some tax increases, including the end of the payroll tax extension (a 2% tax increase whereby the average taxpayer earning $50,000 will pay an additional $1,000 in income taxes), and provided no resolutions to what Ethan Harris, North American economist at Merrill Lynch coined, "the three gorges": (1) the debt ceiling, (2) the sequester (the automatic spending cuts were delayed by two months), and (3) the continuing resolution to fund the government (in the absence of a budget) for fiscal year 2013.

The ongoing negotiations on these issues will likely bring back the brinksmanship and risk of political accidents that were part of the discussions in both mid-2011 and late-2012, likely adding to financial market volatility over the next several months. The Treasury estimates it can use several extraordinary measures to sustain spending until mid-to-late February. The funding for the federal government, which is operating without a budget, expires March 27. While the precise outcome is extremely difficult to predict, the economy and the financial markets have proven to be rather resilient in the wake of these battles. We have all become accustomed to a high level of disparity in Washington and the fact that the worst-case scenarios never seem to materialize. With that said, the U.S. fiscal concerns are not over, especially if Washington intends to satisfy the major credit rating agencies. The conversations on these issues could make the recent negotiations seem like a walk in the park and we would anticipate a heightened level of volatility near-term until we see more clarity regarding the long-term fiscal situation in the U.S.

Nevertheless, global economic momentum is showing signs of improving and the principal macroeconomic risks that concerned investors in 2012 have diminished, largely on the heels of developed market central bank balance sheet expansion. While economies in Europe remain mired in recession, ECB President Mario Draghi, backed by Germany, has taken a more flexible approach to solving the debt and deficit crisis, in part by buying short-term bonds of peripheral countries, and by pledging to do "whatever it takes" to preserve the euro, thereby reducing the risks of a Eurozone breakup. While the deleveraging process in the banking system and economies of southern Europe remains ongoing, and includes risks, financial conditions have improved. The slowly healing economies could see a gradual recovery in 2013 as the ECB measures work their way through the economy and uncertainties fade, reducing the drag to the global economy. Moreover, the euro has rallied more than nine percent since Draghi's speech in late

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July 2012, giving U.S. multinationals a competitive advantage to sell products and services into European markets.

The Chinese economy is staging a recovery led by exports and consumption, removing the anxiety of a so-called "hard landing." The new, reform minded leadership, is in place, and will likely continue to use an active fiscal policy and steady monetary policy to stimulate the economy after seven quarters of slowing growth. Earlier this month, the CEO of aluminum maker Alcoa Inc., Klaus Kleinfeld, indicated on the company's fourth-quarter earnings call that demand in China appears to be coming back. China's economy is expected to continue its sequential momentum and accelerate at least through the middle of 2013, helping to offset Europe's drag on global growth.

In the U.S., the Fed remained extremely accommodative, announcing a new $45 billion per month Treasury buying program in December, which will run in parallel with the $40 billion a month mortgage buying program. The Fed also surprised with changes to its forward rate guidance, removing the calendar reference of mid-2015, and substituting an unemployment rate of 6.5% with the provision that near-term inflation expectations not exceed 2.5%. Additionally, the FOMC minutes from the December meeting revealed that some members of the Fed were in favor of slowing or ending its bond-buying programs sometime this year. The Fed may be signaling a differentiation and policy transition between quantitative easing, which it potentially views as more of a liquidity blanket which can stimulate spending and provide stability, and the Fed funds rate, which it likely views as more of a tool to move the economy towards full employment.

Entering 2013, economic growth in the U.S. is, at long last, improving. Though progress has been slow, unemployment continues to tick lower and is down almost a full percent since last year. Moreover, monthly gains in nonfarm payrolls have been hovering around 150,000 since last summer, with slightly higher private sector payroll growth. House prices were up 7% in the 12 months ending in September, as measured by the S&P/Case-Shiller 20-city index, the strongest start in seven years. If prices continue to gradually move higher in 2013 as expected, residential real estate could add about 0.5% to GDP through both direct investment and the multiplier effects in related areas of the economy. In addition to the recovering housing market, vehicle sales reached a five-year high in 2012, up 13.4% to 14.4 million units, supported by pent-up demand, an improving labor market and a favorable lending environment. Vehicle sales will likely remain a positive contributor to U.S. GDP growth and top 15 million units in 2013.

Additional offsets to the pending drag from the "fiscal cliff" include a large sum of Sandy relief set to be allocated by Washington and others. Ethan Harris at Merrill Lynch estimates the total amount of Sandy spending to be more than $90 billion, including $51 billion in federal aid for Sandy repair, $25 billion from insurance companies, $10 billion in federal aid for flood insurance and over $6 billion from FEMA. Most of this money is set to be spent in the early part of the year. Lastly, lower gasoline prices, currently near a $3.30 per gallon national average, down over 8% from the 2012 average of $3.60, "should translate into billions of dollars in tangible household savings given that the vast majority of Americans rely on automobiles to live their lives," according to AAA's Robert Darbelnet. A drop in gas prices is similar to a tax cut in that it frees up income for spending on other items.

In 2012, the equity markets delivered double-digit gains despite multiple political and economic headwinds. While the near-term risks in equities are skewed to the downside, our base case outlook for 2013 is a slightly better global growth trajectory, with increasing inflation expectations, a modest steepening in the yield curve and positive returns for equities. Policy support, an improving macroeconomic backdrop and the potential for an asset reallocation from bonds to stocks could all prove to be positive catalysts for equity markets in 2013. Given this backdrop, including less growth shock risk than in 2012, we anticipate an incremental addition of more pro-cyclical names as the year progresses, and as U.S. fiscal uncertainties diminish. We will continue to selectively research stocks with sustainable growth characteristics, high levels of free cash flow providing the flexibility to boost dividends and repurchase shares, strong balance sheets and exposure to faster growing markets.