U.S. Market Report

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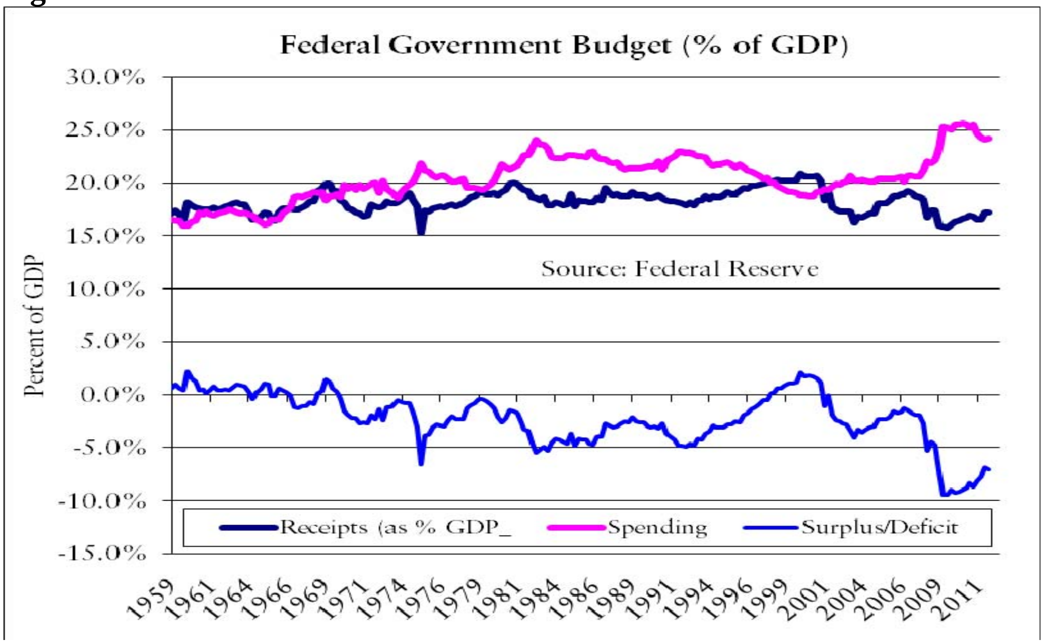
GENERAL OUTLOOK

The economic environment continues to look like a mine field, but stocks keep marching forward. Despite the gains this year, stock valuations are still attractive compared to the alternatives and we would use pull-backs as an opportunity to buy. The list of problems confronting business activity is by now well known to everyone: The U.S. federal government is running a budget deficit equal to 7% of GDP and nothing looks to be done before the November 6th election and perhaps not until next year after the budget has fallen off the "fiscal cliff." U.S. consumers continue to de-lever and spending growth is weak. Exports are coming under pressure because of the weakness in Europe and now a decline in growth in China. Corporate profits are being affected and are expected to be below prior expectations. Despite all that negativity, there are some positives. After several years of decline, the U.S. housing market finally looks to have reached a bottom and is now starting to contribute to growth. And, importantly, the Federal Reserve has taken action—QE3—to offset the deflationary forces that persist as people reduce debt. The immediate impact of Fed policy is to inflate stock and bond prices. One of the oldest sayings on Wall Street is "don't fight the Fed." We think that's good advice.

Figure 1.0



Relative to GDP, the Federal budget deficit has begun to narrow on its own (see Figure 1.0). After plunging during the 2008-9 financial crisis, tax revenues are now in a rising trend. At the same time, government spending has eased off slightly and the Federal budget deficit has narrowed to about 7% of GDP for 2012. Even if nothing is done, tax revenues are likely to trend back toward a natural equilibrium of about 19%-20% of GDP, but that would still leave a budget deficit of about 4% of GDP. And because the number of retired workers collecting social security (the government's public pension) will increase during the years ahead, it is widely accepted that additional efforts are needed to reduce the deficit sooner rather than later.

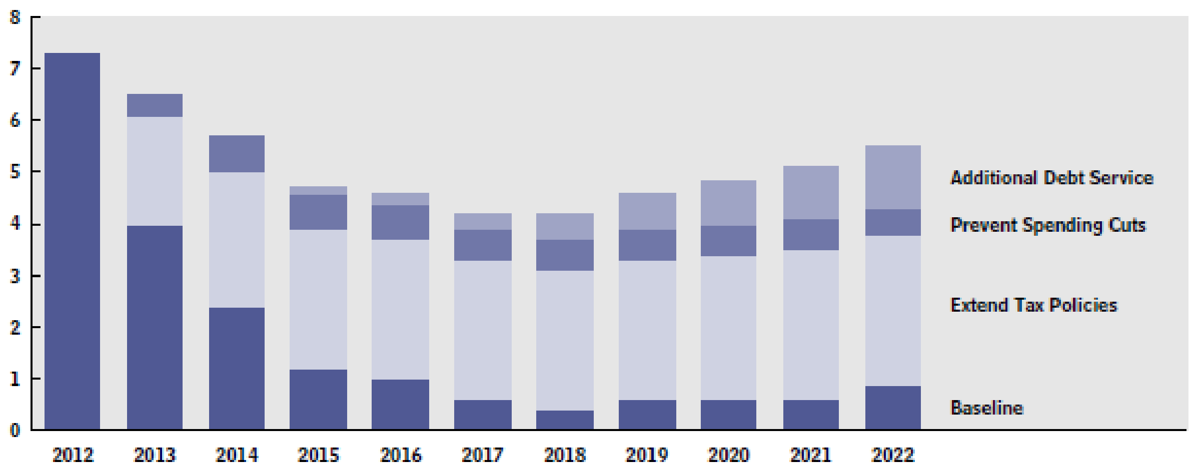
It is almost a certainty that the deficit will be reduced sharply in 2013, but the way it will be done will depend on the outcome of the November election. As it now stands, the "Bush tax cuts" of 2001 and 2003 will expire on January 1st, other taxes related to Obama's healthcare plan will take effect, and there will be automatic cuts to both defense spending and "discretionary spending," which is spending excluding social security and medicare. The Congressional Budget Office (CBO) estimates that if all the automatic changes go through, the deficit will decline to 4.0% of GDP in 2013 and 2.4% in 2014 (see Figure 1.1 below). NOTE: The "Baseline" part of the bars represents the deficit if the automatic cuts go through and the bars stacked on top show how much bigger the deficit will be if those changes don't take place. Whether these automatic changes go through or not depends on the election results.

Unlike Romney, Obama is in favor of letting the Bush tax cuts expire as well as reducing defense spending. So if Obama wins in November, especially if the Republicans continue to control the House of Representatives, then gridlock will occur and the automatic changes are likely to take place. However, if Romney wins, especially if the Republicans gain control of the Senate, the automatic changes will likely be scrapped in favor of a "grand plan" that would reform the tax code, cut discretionary spending, and make structural changes to the big entitlement programs of social security and medicare. Either way, the deficit will shrink further, although probably less so under Romney. There is one other important difference: If the automatic changes go through in 2013 the CBO is predicting that the economy will shrink 0.5%, versus 1.7% growth without the changes. If Romney wins, the combined effects of tax reform, entitlement reform and a surge in business confidence because of the perception that Romney is more pro-growth could mean that the CBO's 1.7% baseline projection for real economic growth may be too low.

Figure 1-1.

Deficits Projected in CBO's Baseline and Under an Alternative Fiscal Scenario

(Percentage of gross domestic product)

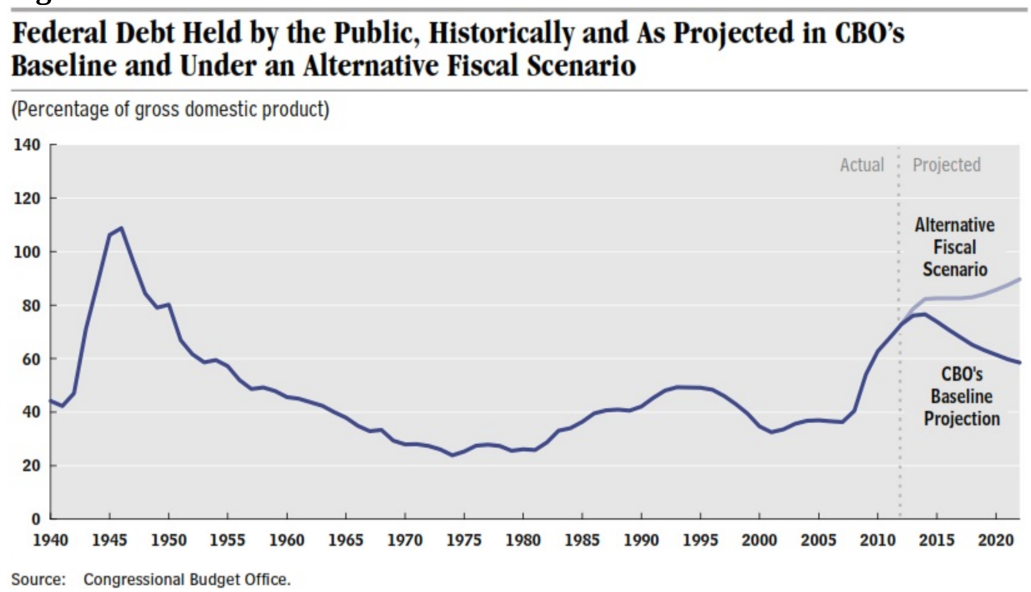


Source: Congressional Budget Office.

Note: "Additional Debt Service" is the amount of interest payments on the additional debt issued to the public that would result from the policies in the alternative fiscal scenario. "Prevent Spending Cuts" involves holding Medicare's payment rates for physicians' services at their current level (rather than permitting them to drop, as scheduled under current law) and preventing the cuts to federal spending that will occur under the automatic enforcement procedures of the Budget Control Act of 2011 from taking effect (but leaving in place the original caps on discretionary appropriations in that legislation). "Extend Tax Policies" reflects the assumptions that expiring tax provisions (other than the payroll tax reduction) are instead extended and that the alternative minimum tax is indexed for inflation.

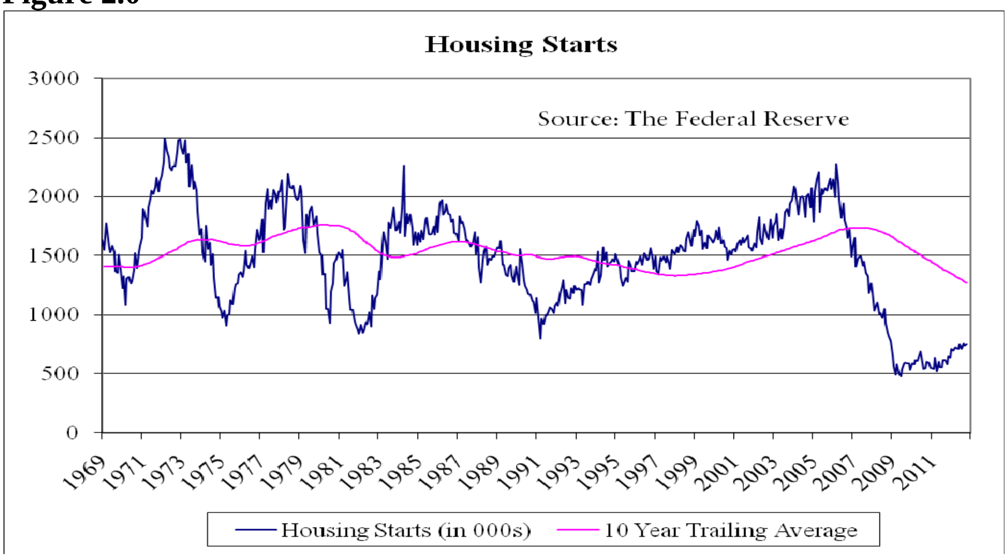
The CBO has forecast that Federal Debt Held by the Public will gradually fall back below 60% under the baseline forecast (See Figure 1.2). A Romney victory would probably mean more debt in the beginning and less later on. The biggest threat to the US budget in the years to come is the cost of public pensions (social security) and medicare (government healthcare) because of the aging of the population. Because Romney would not raise taxes, the deficits will initially be larger if he is elected. However, faster growth in the private sector would likely produce more growth in tax revenues over time. Furthermore, Romney's vice-presidential running mate, Paul Ryan, is well known as a technical policy analyst who has already made comprehensive proposals to reduce deficits related to the social security and medicare. Again, whether Obama or Romney wins, the plan on both sides is to reduce government debt.

Figure 1.2



With all the focus on the risks from the fiscal cliff, it is worth noting that the new home construction industry is now contributing to growth. When the housing bubble collapsed, new home construction went from an annualized rate of more than 2 million units, down to a rate of about 500,000 units. This shrinkage in the new home business deducted almost 4 percentage points from GDP as the industry went from more than 6% of GDP prior to the financial crisis, down to 2.4% of GDP recently. With the natural rate of new household formation well in excess of one million per year, clearly construction of only 500,000 new units was not sustainable. Now, as most of the "good" inventory of used homes has been sold, home prices are rising and new construction is picking up. While the government budget will likely be a drag on growth next year, the housing industry seems to be coming along to the rescue.

Figure 2.0



The Fed announced a plan at its September meeting to purchase $40 billion of mortgage backed securities per month—essentially QE3. The first order effect will be to put downward pressure on bond yields and upward pressure on stock prices. The U.S. has been in a disinflationary trend with falling nominal GDP growth, declining rates of inflation and falling interest rates since 1981. In 2008 and 2009 this pressure became most severe when spending, i.e., nominal GDP, actually was declining on a year-over-year basis. This latest round of quantitative easing is quite controversial because in the most recently reported quarter, nominal GDP was growing at a 3.9% rate, which should be sufficient to accommodate the real growth potential of the U.S. Furthermore, bond yields are already depressed and below spending growth (see Figure 3.0). Critics of the Fed say that slow real growth is due to government fiscal and regulatory policies that are discouraging employment and investment, and that it QE my spur inflation. While this round of QE has the potential to stimulate spending, and thus put upward pressure on inflation, the evidence so far suggests that new money is flowing into stocks and not necessarily spending on goods and services. As shown in Figure 3.1, money velocity, which is the annual turnover of M2, has been declining rapidly. In other words, people are hoarding money and not spending it.

Figure 3.0

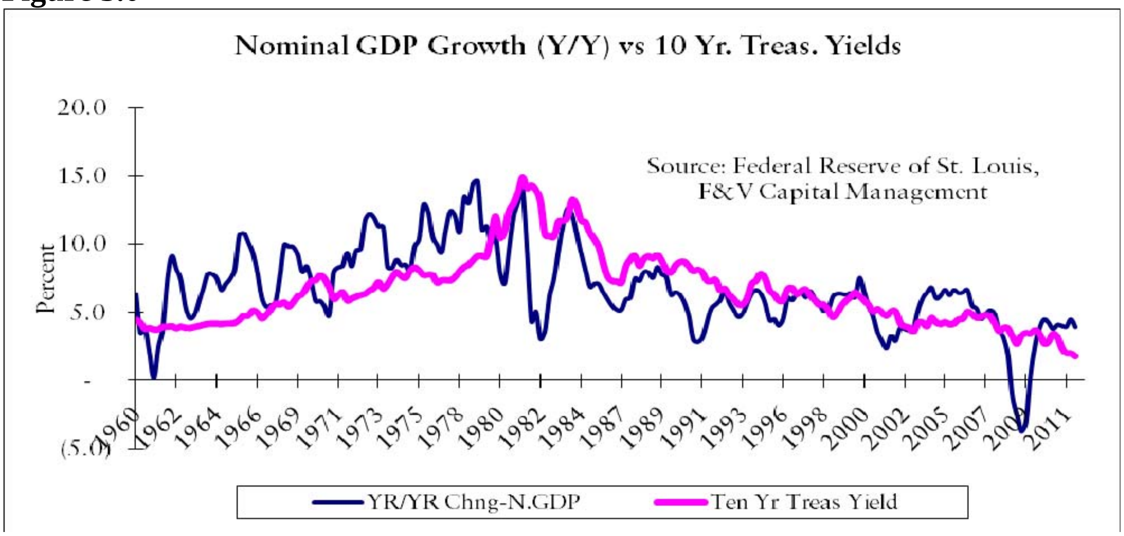
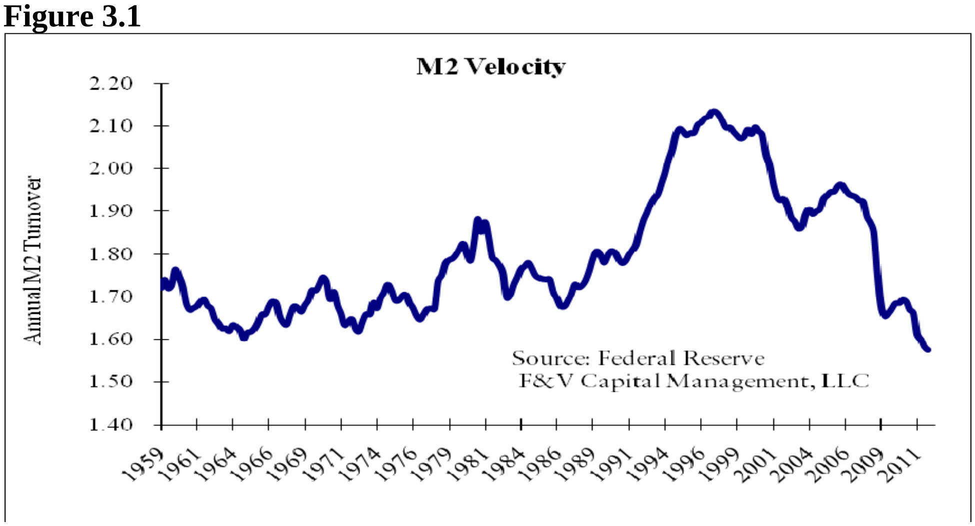
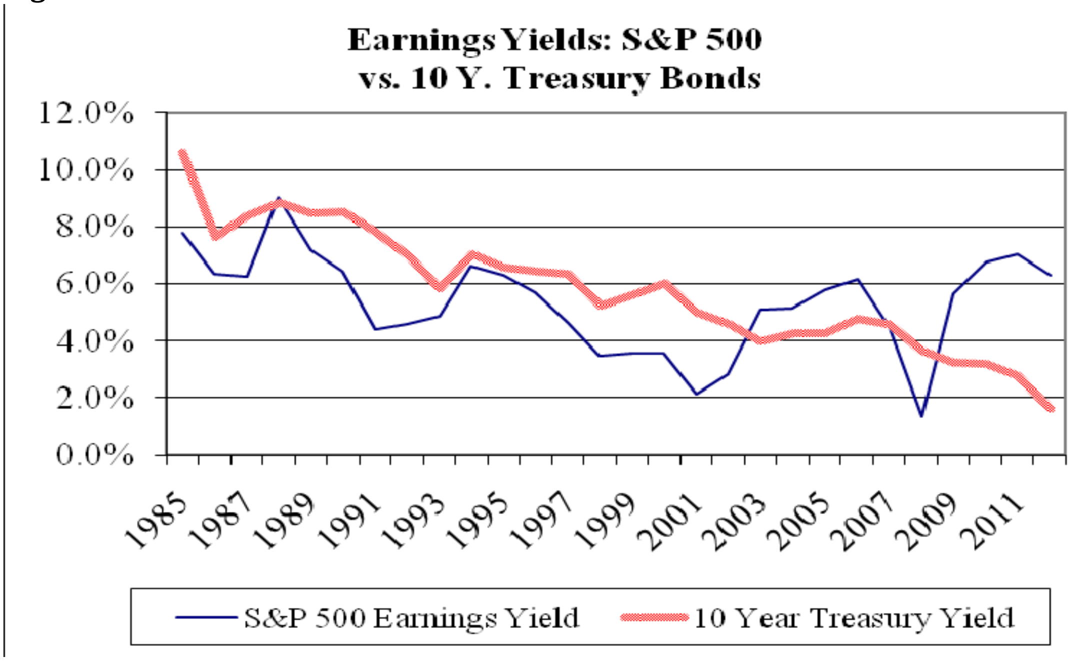


Figure 3.1



Since people are not inclined to spend money—the emphasis is on saving and accumulating money, and because interest rates are already so low, the Fed's QE has the effect of lifting stock prices. Figure 4.0 compares the yield on 10 year treasury bonds with the earnings yield for the S&P 500 (NOTE: just as a bond yield is interest divided by the bond price, the earnings yield is earnings divided by the S&P 500 price). Historically earnings yields have been below bond yields because earnings tend to grow over time whereas the interest payments on bonds are fixed. However, today, the earnings yield on the S&P 500 is above 6%, while the yield on 10 year treasury bonds is below 2%. The yield on bonds is so paltry that investors, who generally are very risk adverse and suspicious of stocks, are being prodded to allocate capital to equities.

Figure 4.0



We have grown concerned that there could actually be an upward spike in stock prices. Some technical analysts--those who look at stock charts and other indicators of market activity, have pointed out that stock trading volume has been low during the recent rise in prices and that such low volume is a negative indicator. However, there is another possibility: Levels of stock ownership are extremely low from an historical perspective and cash balances are at record highs: Many portfolio managers and other investors consider themselves under exposed to equities and thus are not willing to sell stock and reduce their current equity exposure. Even the marginal increase in demand from equities being engineered by the Fed is pushing prices higher because that is the only way to entice current stock holders to sell some of the shares they hold. Keep in mind as well that we are in an environment where even corporations have trillions of dollars on their balance sheets and are buying back their own stock and thereby reducing the supply of stock available. If there is some significant change in market sentiment, such as a major breakthrough in Europe or an election result in the US that convinces investors that growth will reaccelerate, demand for stocks could sharply increase. And because stock investors already feel underexposed and unwilling to sell, prices could rise very fast. What happens after that is another story that we will tell later. But for now, beware the possibility that very few people are considering – a huge bull market in equities.