Outlook for January, 2013: "Dodging Bullets…"

The last minute deal to avert the so called fiscal-cliff means investors looking for more permanency in policy matters are unlikely to find it in the US. Indeed, the deal has merely "kicked the ***proverbial can down the road***" and many of Washington DC's shenanigans are unfortunately likely to be repeated in a few short months. If anything, it feels like financial markets continue to dodge bullets through a mine field (how is that for a pleasing visual?)!

The Bureau of Labor Statistics' employment report showed marginal improvements in the labor market. In December, nonfarm payrolls gained 155,000, accompanied by a gain of 14k in net revisions for October and November. December's payroll numbers bring the monthly average job growth for 2012 to 153k; the same average we saw in 2011.

Breaking it down by labor market sectors, December's report showed gains in education and health services (+65k), leisure and hospitality (+31k), construction (+30k), and manufacturing (+25k). Job losses in government (-13k), retail trade (-11k), and information (-9k), softened the monthly gain.

The household survey pegged the unemployment rate at 7.8% - an increase of one-tenth from November's number. A broader measure of unemployment that includes the "marginally" attached and discouraged /part-time workers, known as the "U-6" measure, also remained unchanged at 14.4% (down from 15.2% in December 2011).

Now that we have a full year to look back on, here's what has changed (or remained the same) in the labor market: The participation rate has declined slightly from 64% to 63.6%, with the employment/population ratio unchanged at 58.6%. Labor market segments by age and ethnicity improved marginally from a year ago except for teenagers (23.5% unemployment vs. 22.9% a year ago).

The number of unemployed has declined from around 13 million people to 12 million. However, persons considered "not in the labor force" for various statistical reasons has climbed from 2.5 million to 2.6 million. The number of discouraged workers has also increased over the past year. Economists frequently look at the number of long-term unemployed to measure the robustness of the recovery: at a still high 4.8 million people (5.6 million in 2011), we are not at all encouraged that the labor market is improving in a ***sustainable*** way.

Of course, the news is not all bad: The ISM's non-manufacturing index (a reflection of activity in the service sector) strengthened to 56.1 in December from 54.7 in November. Several of its main components point to increased future demand. Positive readings from the ISM Manufacturing index, and regional business surveys (Philadelphia, Chicago, and Dallas) suggest moderate expansion is in the works.

The Bureau of Economic Analysis of the Department of Commerce's final estimate of 3rd quarter GDP surprised on the upside. Improvements to consumption, exports, nonresidential fixed investment, and government purchases propelled the reading higher, settling in at 3.1% growth (q/q/, seasonally adjusted annual rate). This is a marked improvement from 2nd quarter's 1.3% pace of growth.

Financial markets have breathed a ***sigh of relief*** at the last minute deal negotiated to avoid the fiscal-cliff. Indeed, both the Senate and the House "burned the midnight oil" passing legislation in the wee hours of the morning to avoid tax increases and postponing the automatic sequestration of spending that would have occurred. Included in the legislation were also the "doc fix" and increases to the estate tax exemption limits that were ***long overdue***.

Despite the euphoria surrounding the fiscal cliff deal, we suspect that the shenanigans that Washington DC is famous for are far from over! There is a new fight brewing on raising the debt ceiling, with the Treasury already running out of debt ceiling room by the end of last year (2012). In addition, the automatic sequestration of expenditures has only been postponed until March 1st – which needs to be dealt with.

Furthermore, the continuing resolution which authorizes Federal Government operations also expires on

March 27th, 2013 – which if not extended would lead to a shutdown of parts of the vast Federal Government bureaucracy. In other words, Congress and the Administration will be at it yet again in a few short months – providing little respite for those of us who believe that policy (especially of the fiscal kind) ought to be a longer term exercise!

It is also quite depressing to note that the much vaunted fiscal deal signed into law by President Obama on New Year's Day does not in any way shape or form address the ***longer term fiscal issues*** that we face as a country. Indeed, the warning that is Greece's experience appears to beckon like a siren song if we fail to address entitlement spending on Medicare, Medicaid and Social Security.

While fixing social security is a matter of simple arithmetic – for example, raising the age when younger people who currently contribute to the system can start collecting benefits, and increasing the contributions for those that can afford to do so, the solutions for Medicare and Medicaid are obviously much more elusive. In addition, the Affordable Care Act (otherwise known as "Obamacare") has managed to place a heavier burden on states' finances without ***"bending the cost curve".***

All in all, the fiscal situation in the US has gone from bad to worse and it looks to us like there is very little political will (nay, desire) to even attempt a longer term solution to this mess. The US Dollar's status as a ***reserve currency*** permits us the luxury of having lower interest rates given the breadth and depth of our capital markets – which remains the envy of many countries the world over. However, our politicians appear to have a predilection to play with fire without understanding the risks of their inaction. Dodging bullets indeed!

Farther afield, the Japanese population elected the LDP back to power with Shinzo Abe being elected as the new Prime Minister. Mr. Abe has made it very clear that he will put pressure on the Bank of Japan to set a ***lower bound*** for inflation in Japan – thus essentially stimulating the economy with further quantitative easing. In typical reaction, the Yen has weakened against both the Euro and the US Dollar while the comatose Nikkei stock index appears to have sprung to life again!

Europe also appears to be dodging bullets from a fiscal standpoint: The European Central Bank's largesse and ample provision of liquidity continue to propel equity prices higher. With the European economy starting the year in a recession, the real question is how deep a recession is it going to be? It looks to us like the intransigent issues relating to lack of labor mobility in the continent and governments having promised more than they can deliver are unlikely to go away here either. Nonetheless, given the sharp appreciation we have seen in equity markets across the continent, one wonders whether the worst of Europe's problems might largely be behind us.

Earnings expectations for the S&P500 continue to be ***ratcheted down*** as analysts see companies' results. Since we are on the cusp of the earnings season for 4Q2012 reports, it is still too early to gauge how companies did in the quarter just past. However, the consensus for 4Q2012 for the S&P500 which was in the $30 per share range even as late as last summer now appears to be closer to $25 per share for the quarter (an almost 17% decline). For the entire year 2013 it looks like the consensus is now expecting earnings in the $112 range per share (while they were as high as $120 earlier last summer – a more modest 7% decline, but a ratcheting down nonetheless).

Equity ***market valuations*** using rubrics like the Price to Earnings ratio suggest valuations are ***fair.*** In other words, we would characterize valuations as neither "cheap" nor "expensive". However, much of the assessment depends on one's sense of where the economy is in the cycle, the sustainability of earnings as well as the direction of interest rates – all variables that are hard to pin down specifically!

We do not want to give our regular readers the mistaken impression that financial markets are in dire shape: Quite the contrary, we continue to believe that there will be plenty of opportunities to make money in sectors and parts of the market that are under-researched or under-owned. Also, just as Municipal fixed income securities put in a surprisingly strong performance in 2012, we fully expect there will be sectors and sub-asset classes that will do well in 2013.

In summary, financial markets continue to dodge bullets amidst a sea of fiscal uncertainty and political wrangling. However, our abiding faith in a fully diversified portfolio - that has a balanced approach to both risk and return - as the main way to attain favorable investment outcomes over the long haul remains steadfast.

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