Are We There Yet? Not quite.
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By Carl Scholtz

As a new year begins, it is appropriate to reflect on the past twelve months and give some thoughts on how we see 2013 playing out. We have seen some rather remarkable events with the European Union nearly collapsing, emerging market growth slowing dramatically against all odds, and the U.S. potentially inflicting the first ever “self-made” recession. But in spite of all these seemingly devastating problems, the market persevered on with the S&P 500 returning 16.0% in 2012. Why did this occur? The short answer is that the market is forward looking and the problems are in the process of resolving. Further, valuations (especially when you think about record low bond yields) are very compelling. While it is unlikely that 2013 will be a smooth ride, by year end, we are optimistic that the markets will put in another solid move higher, potentially reaching all-time levels.

In our prior quarterly letters during 2012, we have discussed at length what had essentially become the “holy trinity” of economic worries: European Union economic collapse, a China slowdown, and the U.S. fiscal cliff. The positive resolution of these issues will likely be the springboard for a new bull market. So, let’s see where we are on the checklist.

1) Mitigate a European crisis: check. Through the aggressive, unprecedented moves of the ECB and reasonable centrist policies out of Germany’s Merkel, it seems as though the disaster scenario that many have feared has been taken off the table. Sure, most EU countries are experiencing some sort of recession with record unemployment rates (Spain’s unemployment exceeds 25%), but U.S. investors shouldn’t worry unless Europe falls into a depression – an unlikely outcome. Further, several recently proposed policies are likely to significantly reduce the probability of this calamity from happening again. The much discussed “banking union” would essentially take individual EU country governments off the hook for their region’s banking woes and necessary bailouts. This was a major problem for Spain.

2) Engineer a soft landing and re-acceleration in China: check. China wasn’t going to grow its GDP double digits in perpetuity, but around the middle of 2012 it looked like it may slip to low single digit growth or worse. While government data continued to project 7-8% GDP growth throughout the year, most indicators such as PMI data, electricity usage, and company survey data suggested 7-8% GDP growth was a farce. However, these indicators finally turned during the fall making 7-8% far more believable. ISI strongly believes the economy has bottomed and we agree. This growth will be aided by the beginning of new leadership which took power on 11/8/12 after the prior regime’s 10-yr reign. China cares a lot about optics and the new leadership will want the beginning of their term to go well. With debt to GDP of less than 10% and targeted 1-yr lending rates still at 3.0%, the government has plenty of ammo to work with. As a result, we have
made an exception to our investment style by investing in a Chinese ETF (MCHI) as we typically do not like to buy ETFs.

3) Mitigate near-term headwinds from the fiscal cliff while reducing future debt problems: incomplete. Yes, the markets rallied due to the deal signed on 1/2/13 which raised the marginal tax rates on the wealthy, among other things. However, we are not fully out of the woods, and this crisis still needs to be fixed. We do not have a conclusion on the debt ceiling or the $110bn sequestration, and there has been minimal progress on entitlements which are ultimately the key to our long-term fiscal solvency. In any event, the announced deal and a subsequent “debt ceiling” deal will undoubtedly have a drag on the economy, the question is by how much? Raising the payroll tax back to 6.2% alone is a 0.60-0.70% headwind on the economy and experts seem to pinpoint around 1.0-1.5% drag from this first deal. Given that GDP is forecasted to grow around 1.4% in Q412 (after 3.1% in Q312), we do not have a ton of margin for error. That said, we are optimistic that any deal will not have a dire economic drag and that U.S. GDP growth in 2013 will be fine (but more on that later).

Assuming the remainder of the fiscal cliff gets resolved, the markets should put in a strong year in 2013. This is in contrast to many stock “pundits” pointing to a rather morose 2013. They will say that Q4 earnings will be weak, and you should sell this rally. Frankly, I think they may be right on the weak earnings reports, but wrong on the ultimate conclusion. The U.S. economy did slow and many industries including retail and capital equipment will feel pain when they report earnings somewhere around February to March. But there are a few things that these pundits are missing. First of all, Q2-Q3 results were poor and the market barely blinked. Second, Q4 is weak in part because of a pullback in investment and hiring by businesses waiting to see what the ‘rules’ may be. This has created some pent-up demand that will likely flood the economy as the debt ceiling is resolved. Third, while clearly weak in Q4, the consumer’s resiliency going forward may be underestimated. The payroll-tax increase notwithstanding, the consumer is well positioned given its low debt service burden and modest energy cost pressures. While many cite the record high consumer loan levels, they fail to mention that debt and interest payments are at 30-yr lows (10.6% of after-tax income) and total consumer debt is well below peak levels as a percent of GDP. Finally, any “debt ceiling” deal will undoubtedly be good for the economy near-term because the Democrats are calling the shots. They are not going to allow any big deficit reduction legislation on entitlements or deep spending cuts. While definitely a negative for the long-term fiscal solvency of the U.S., the next few years should be business as usual. The length of the debt ceiling push out will be a key factor. Thus, post-fiscal debt deal, we feel that companies can frame a positive outlook as they see the light at the end of the tunnel and the market should pick up on this.

Ultimately, the Bears are fighting a losing battle because valuations remain very attractive especially in-light of alternative investment options. The Fed is essentially forcing investors to shift more money into equities that have become increasingly compelling. Not only did the Fed announce an unlimited bond buying program in September of $40bn/mos., but their plan to continue with Operation Twist (even though they have no more short-term securities to sell) means the Fed has essentially added another $45bn/mos in “printing”. That means the Fed will be pumping roughly $1 trillion into the capital markets in 2013 which will continue to push
many investors into other investments besides treasuries and high-grade bonds. Junk bonds have already seen a big boost along with safe, high-yielding equities. The rest of the equity market should therefore see this tailwind soon.

2013 is therefore going to be about how the global economy got back on its feet and began a slow grind higher. China is fixed and re-accelerating, EU will likely bottom soon as confidence is repairing, and the U.S. fiscal drag won’t be that bad. Pair those outcomes with a recovering U.S. Housing market, mild commodity markets (especially energy such as oil and natural gas), and global monetary easing and you are set up for solid returns.

The bottom line is that if you are willing to endure some potentially large swings, owning equity securities now probably makes sense. For us, we are most of the way there, but are holding back a little just to make sure our suspicions prove correct and to take advantage of some unforeseen volatility. We are still holding some cash, but we’ve moved out of the less liquid defensive securities (such as convertible preferred’s) in order to react quickly to the ever changing market. In this environment, liquidity is key. In terms of sector allocations, we remain positive on the healthcare (especially companies with low government reimbursement exposure), technology, and industrial sectors. These sectors should be less affected than others by any “debt ceiling” deal with the latter two appearing particularly undervalued to us. In conclusion, while the recent run-up does make us think there will likely be a better near-term buying opportunity over the next 4-5 weeks, we remain constructive overall on the market for 2013.