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2013 – THE YEAR AHEAD

The U. S. election is history, but substantial questions still remain. For investors there are three significant unknowns: the fate of the eurozone, the rate of Chinese economic growth, and of course, the eventual outcome of our own economic and fiscal difficulties. As we look forward, these issues are the likeliest sources of investment risk. But in theory, what is currently known is already priced into existing valuations. In other words, for the financial markets, what occurs next is more important than what has already happened. And on this score, there are a number of emerging positive trends which we will discuss herein.

2013 seems a pivotal year. What lies ahead for this nation does not seem so much dependent upon the outcome of the 2012 election, as it does on the Administration and Congress getting their collective act together and doing what so desperately needs to be done. There is a limit to how much money a government can borrow and we are straying too close to the black hole of excessive debt, beyond which there no longer exists a viable solution. The fact that we have reached a point where the negative consequences of doing nothing far outweigh the alternative greatly increases the odds that our elected officials will compromise enough to do something constructive. 2013 is not an election year, but 2014 is. The time is now.

So with those thoughts in mind, we present "*2013 – The Year Ahead*." We remind you, however, that while we are attempting to forecast the future, our continued investment success in these volatile times will depend much more on our ability to interpret and adjust to trends and events as new information becomes available.

The Economy

Periodic recessions are inevitable. Typically, as expansions age, excesses develop that increase the risks of inflation. Then, the Federal Reserve Board tightens monetary policy and a downturn ensues, most often led by housing and autos. The typical economic cycle lasts about four years. Given that the current expansion started in the spring of 2009, this one is getting long in the tooth by historical standards.

Yet, this economic expansion has been far from typical. The last downturn was financially driven and, as in previous post credit-crisis recoveries, the subsequent pickup in investment spending, housing, and jobs growth has been agonizingly slow. In response to the tepid economy and to concerns about the risk of deflation, the lack of private credit growth, and the absence of meaningful fiscal stimulus, the Fed has driven down interest rates and provided an extraordinary amount of monetary stimulus (a.k.a. quantitative easing).

More recently, a variety of economic inputs have shown signs of improvement. Housing is on a definite upswing, consumer spending is hanging in there, credit is gradually becoming more available, and auto sales seem to be picking up, as well. Corporate balance sheets are in excellent shape and there are almost none of the typical excesses in credit or capacity that bring expansions to an end. Thus, in the absence of outside influences, the current slow growth environment would seem likely to persist.

However, the current environment is not lacking outside influences, both economic and governmental. Over the years, U.S. corporate profits have become increasingly global, and there is an ongoing slowdown in the world economy. Recent indications are that China's growth may soon pick up, but the eurozone economy continues to deteriorate and has probably already entered a full-blown recession. It appears that the European authorities did not fully understand the nature of their difficulties. One cannot fix the problems of deteriorating competitiveness and excessive debt burdens with austerity alone.
As for the influence of our own government's still-undecided policies, there are a lot of moving parts, the economic consequences of which are hard to handicap. What is known, however, is that business and consumer confidence are crucial elements of growth and there is little doubt that the ongoing uncertainties regarding the fiscal cliff, taxation, and regulation continue to suppress spending, investment, and jobs growth. Many of the rules under which companies operate have been in flux since the Great Recession.

As this report goes to press, our politicians have failed to reach a compromise that would avert the fiscal cliff. While not doing so was clearly irresponsible, we are still hopeful of some limited, eleventh-hour adjustments. How much effect the remaining drag will have on the overall economy is an open question, but growth this year will definitely be slower than it would have been otherwise. The reality is that December 31 is not an absolute deadline, as laws can be passed with retroactive impact. However, our upcoming encounter with the debt ceiling does create such a deadline. For that reason, we expect that whatever remains of the fiscal cliff will be addressed during the first quarter of 2013 in conjunction with negotiations on the debt ceiling, with some or all of the eventual compromise being effective as of January 1. Given the current political rancor, however, we are less optimistic about a grand deal that includes major tax reform and entitlement changes next year. While our investment posture is focused on the long term, we understand that we will probably have to adjust our economic forecast and expectations as Congress and the President work their way through the process.

With all that is going on in Washington, we suspect that U.S. economic growth in the first half of 2013 will be close to flat line. Recession is a distinct possibility. But if that is the case, the downturn will likely be short and shallow, followed by an improving trend later in the year, spurred by pent-up investment spending and continuing improvement in the housing and auto sectors.

There are a number of longer term positives for the economy. In BTR's 2012 *Investment Strategy Updates,* we have written about three significant trends: The first is that U.S.-developed technologies are leading to sizable increases in the domestic production of both oil and gas. A recent report by the International Energy Agency predicted that before 2020 the U.S. would overtake Saudi Arabia to become the world's biggest oil producer, and likely attain energy independence ten years later. Meaningful progress has been made, and input costs for manufacturing have already become advantageous relative to the rest of the world. Stemming in part from this development, the second trend is the increasing competitiveness of and budding revival in U.S. manufacturing. We would highlight recent announcements by the likes of General Electric and Apple to move production back onshore. The third trend, which could be more immediately impactful, is the improving U.S. housing cycle, as evidenced by the recent improvements in housing prices and home-builder confidence. In addition, there is the continuing development of newer technologies such as cloud computing and networked knowledge, as well as significant advances in biotechnology. Taken together, these advances will help drive productivity and future growth. One needs look no further than the booming San Francisco office market to witness the rapid growth in these arenas.

One of the longer-term issues for this nation is income divergence. In most of the past century, the benefits of economic expansion flowed more evenly through the various socioeconomic classes. But the more recent waves of technological and manufacturing innovation have disproportionately benefitted the better educated. As a whole, the U.S. educational system is out of sync with the current environment of innovation and technology-based manufacturing. Our students rank well down the list of their global counterparts in math and science skills. Divergence between the classes has been further exacerbated by open global trade and the increasing capabilities of lower-cost, developing-nation workers.

Inflation, Interest Rates, and the Bond Market

The battle rages between the forces of deflation currently existing in the global economy and the intense reflationary efforts by the world's central bankers. It has been that way ever since the Great Recession. A weak global economy, persistent high unemployment, and continuing private sector deleveraging are all highly deflationary in their effect. Hoped-for government action to reduce our deficit would actually be deflationary, as well. In an attempt to counter these deflationary forces, the U.S. Federal Reserve Board has created vast new monetary reserves.

But how much new money is enough to offset the risk of deflation, and how much is too much, which would result in rising rates of inflation? After all, inflation is and always has been a monetary phenomenon – too much money chasing too few goods. The answer lies in the velocity of money – simply said, the rate at which money recirculates through the economy. Quantitative easing has created huge free reserves, but only to have them trapped in the system without producing sufficient credit expansion. The velocity of money has been falling for much of the past five years.

Can the Fed's enormous reflation effort become an inflation problem later? Of course, but that isn't likely without a much stronger economy, accompanied by accelerating loan growth and declining unemployment – a combination that we think is still somewhat further off in time. Even then, the resulting inflationary pressure could be offset by subsequently raising interest rates and draining free reserves from the system.

So what about interest rates? The very low level of current interest rates is symptomatic of today's deflationary environment. It also reflects the Fed's stated commitment to keep rates low, as well as the global view of the U.S. financial system as a safe port in a stormy world. But such a view is ultimately dependent upon meaningful progress towards U.S. fiscal reform. Absent such progress, bond market investors will inevitably demand significantly higher U.S. government interest rates, much as they have already done in Greece, Spain, and Italy.

We see little to attract us to fixed-income investments, except to use them as a placeholder – a portfolio offset to one's more volatile holdings. Current fixed-income yields are extraordinarily low, and the risk/reward tradeoff from these levels seems highly skewed against investors owning anything other than very short-term maturities and occasional special situations. Our expectation is that a much better bond market entry point lies ahead but, unfortunately, probably not in the near future.

The Stock Market

Whether or not to invest in stocks at this point is not only a question of investor time horizon, but also of valuation and the relative attractiveness of the primary alternatives. Stock market returns are a function of earnings growth, dividend yield, and changes in valuation. Over the long term, corporate earnings grow in line with nominal GDP. But as already mentioned, our economic expectations for 2013 are quite modest. Thus, we fear that analyst earnings expectations for the year ahead may be too high, potentially leading to investor disappointment. Dividend yields are approximately 2% overall, an improvement from recent years, but not high by historical standards. And while valuations, which have trended lower since the bursting of the technology bubble more than a decade ago, are relatively inexpensive, they seem more or less consistent with the current environment of subdued economic growth. Taken together these factors don't appear to foreshadow rising stock prices.

Clearly though, the stock market is a discounting mechanism. While no doubt there are troubles in the world, both economic and geopolitical, for the most part they are well publicized and may be largely priced into current valuations. And, as mentioned earlier, there are a number of meaningful positive trends that investors will begin to price in at some point. An additional positive for stocks is the current lack of attractive alternatives. The returns on cash and quality fixed-income investments are actually negative after considering inflation. At the same time, there are a number of high-quality stocks which are historically inexpensive and sport dividend yields greater than 3%, which is meaningfully higher than the nominal returns on either cash or bonds. Many of these companies are household names which should continue to grow earnings and dividends over time. So, it is hard to imagine that their stocks will be priced lower three or four years from now than they are today.

As we have been reminded in recent years, the stock market can go sideways for long periods of time. A similar period of consolidation occurred during the 1970s. Then, as now, corporate earnings continued to grow, but so too did the general investor distaste for stocks. Eventually stocks became attractively valued and historically under owned. Inevitably, investors shifted their focus to the more positive developments. The 1970s consolidation ended with a sustained bull market in the early and mid-1980s. Our expectation is that another big bull market will unfold on the other side of the current consolidation, but probably not yet. In the meantime, volatility and the general sideways trend seem likely to continue – perhaps for as much as two to four more years. Our best guess is that the bottom of the current stock market cycle was seen in early 2009. Our expectation is for reasonable investment returns from equities during the coming few years, particularly compared to those of the obvious alternatives.

The stock market looks to the future and difficult markets don't last forever. One way or another, the current set of problems will pass. Then, as occurred during the early '80s, the positive investment case can gain traction. In the meantime, we intend to emphasize quality and dividend yield, while remaining opportunistic. We also plan to continue our quest for conservative ways to participate in the new growth arenas.

Conclusion

How do we put this all together? Over its history, the U.S. has possessed a unique set of competitive advantages. As a nation we are blessed with abundant natural resources. Through the application of science and technology, the rule of law, and a strong work ethic, we have enjoyed an unparalleled culture of entrepreneurship. Yet in many ways our commitment to excellence has begun to erode. Some of the causes are evolutionary, but most seem self-imposed.

Winston Churchill once remarked that *"Americans can always be counted on to do the right thing… after they have exhausted all other possibilities."* Congress is very good at doing nothing, but we have reached the point where doing nothing seems to guarantee the worst outcome. It is time for our elected officials to deal with our soaring debt. In the process, they should also provide some permanence to our tax structure and regulatory environment. U.S. corporations are in excellent financial condition and have always been highly adaptive. But businesses need to be able to rely on a defined set of rules – a predictable and competitive tax and regulatory regime. We must all hope that the President and Congress rise to the challenge.

Regarding the year ahead, our economic expectations are modest at best. Recession is a distinct possibility, but our opinion is that such an occurrence would be short and mild, and perhaps be followed by surprisingly good growth later in the year. From an investment standpoint, we recognize that the primary uncertainties are still there. Some, such as China's growth rate and the U.S. housing market, seem to be turning for the better. Others are ongoing, but do not currently seem to be getting any worse. For the most part, we think that a fairly pessimistic set of fears and conditions are baked into current stock market valuations. Meanwhile, the positive trends continue to gain strength.

The year ahead may be bumpy, but high-quality, dividend-paying stocks are attractively valued, and there is a distinct lack of attractive investment alternatives. The start of the next secular bull market may not yet be upon us, but as we learned from the year just past, patience and a steady hand can provide reasonable investment returns in such an environment. We are investors, not traders. Our plan is to maintain a high-quality, total-return approach to client portfolios, and take advantage of the expected volatility.

As we enter the new year we are optimistic about our nation's future. As a final note, we wish all of our friends and clients peace, joy, health, and prosperity in the New Year and for many years to come.