Market Update • December 4, 2012

Resilient Markets Mask Greater Concerns in Real Economy

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Equity markets have settled into an eerie calm in recent weeks; with volatility — as reflected by the CBOE Volatility Index, or VIX — near a three-year low, one might assume all's right with the world. But it isn't, as can be seen clearly in the real economy. Europe is in recession. Japan's exports have collapsed, and a recession is on its way there. U.S. corporate earnings are in the first leg of a recession, and the country may celebrate the new year by plunging off the so-called "fiscal cliff". The tug of war between the markets and the economy is confounding, and in the end only one of them can be right.

Markets Have Been Resilient

These markets can sure take a punch. Immediately after the November elections, equity markets reeled, with the S&P 500 plummeting more than 5% in a week and a half. However, the index almost fully recovered that loss in the same amount of time, leaving investors exasperated but calmed by a timely Thanksgiving Day feast and ultimately a positive November.

November was also a positive month for a broadly diversified global portfolio (see Figure 1). Standout performers were U.S. mid-cap stocks and EAFE (Europe, Australasia and the Far East) stocks. Mid-cap and large-cap U.S. stocks have been in a horse race for supremacy this year, with several lead changes along the way; as we enter the home stretch, mid-caps have retaken the lead. EAFE stocks, dominated by Europe, have come from the back of the pack to pull near even with U.S. equities; they led all asset classes in November, with a total return of 2.4%.

Global Risks Continue Unabated

The central banks have conspired to keep the pedal to the metal; that is, to keep liquidity abundant and bond yields low. Although low rates facilitate growth, they alone cannot create growth. Moreover, they do not solve structural problems, as the prevailing risks abundantly show.

- Europe re-entered recession during 2012. The European Union (EU) summit on its fiscal plan collapsed, while political will for an EU banking union — including a single bank supervisor — has weakened. In addition, economic downturns in Italy, Spain, Portugal and Greece continue to be accompanied by anti-austerity riots.
- France was stripped of its Aaa credit rating by Moody's. Meanwhile, the government raised the top marginal income tax rates to 75% and threatened a global steel firm with nationalization.
- Europe's two bailout funds — the ESM and EFSF — lost their AAA credit ratings.
- After its worst year of exports since 2009, Japan likely slipped back into recession.
- China's hard-landing risks increased as 2012 went on, and the efficacy of state capitalism remains in question.
- In the U.S., a draconian tax and spending plan — dubbed the fiscal cliff — will go into effect unless negotiations are able to produce a more salubrious package. More about this below.

Something Will Happen January 1

The noise surrounding the fiscal cliff is louder than the Macy's Thanksgiving Day Parade; the sound and the fury hardly matter, however, as the spending cuts and tax increases that were agreed to as part of last year's debt-ceiling debacle will become the law of the

Executive Summary

- **Though equity markets have been calm, the real economy tells a different story.**
- **If our leaders in Washington aren't able to arrive at a compromise, January 1 will mark the beginning of the country's first "scheduled recession", though third quarter corporate earnings suggest a global slowdown is evident.**
- **Don't be surprised to see a Christmas rally should Congress kick the fiscal can down the road and the Fed extend Operation Twist.**

Figure 1: Global Assets All Positive YTD And Global Equity All Positive for November

Index	Nov-12	QTD	YTD
Equity			
S&P 500	0.6	(1.3)	15.0
S&P MidCap 400	2.2	1.4	15.4
S&P SmallCap 600	1.0	(1.1)	12.6
Global REITs	1.5	2.3	25.0
EAFE	2.4	3.3	14.2
Emerging Markets	0.6	1.6	9.4
Average	1.4	1.0	15.2
Fixed Income			
Corporate	(0.2)	1.1	9.9
U.S. Treasury 20+	1.4	1.2	5.6
Global Aggregate	(0.0)	(0.2)	4.7
High Yield	0.8	1.7	14.0
Average	0.5	1.0	8.5
Overall Average	**1.0**	**1.0**	**12.6**

Source: ING Global Perspectives, FactSet land on January 1 unless a compromise can be reached. The well-intended but ill-conceived plan socks it to taxpayers with extreme increases in every conceivable federal tax and with draconian spending cuts called "sequestration".

Normally, the markets like certainty; however, they are unlikely to react positively to what beginning New Year's Day 2013 will go down in history as the country's first "scheduled recession", absent Congressional action. For additional color, we offer Figure 2, which compares the current law with the changes included in the fiscal-cliff law.

It is important to note that, while not necessarily good schemes, both the fiscal-cliff law and the Simpson-Bowles plan definitively rein in current and future debt and thus likely sidestep another credit-rating downgrade from Standard & Poor's. Any legislative tinkering or window dressing that does not clearly achieve debt reduction will increase the risk of another downgrade of U.S. Treasuries, with unknown but likely serious consequences in global financial markets.

The Real Economy Has Slowed

The third quarter earnings season is nearly complete; we appear to be entering a corporate profits recession, quite likely the "canary in the coal mine", signaling that both the U.S. and global economies have serious growth problems.

But Armageddon it is not. For example, even though year-over-year earnings growth for the third quarter was negative, it was still the *third-best* quarter in history. And there are some positive indicators — including broadening manufacturing, consumer strength bolstered by a resurgent housing industry, and tectonic shifts such as global trade and an energy revolution — that are catalysts for growth.

Those who believe taxes don't matter should consider the significant evidence of tax-motivated activity in the real economy. Data provider Markit reports that more than 100 corporations have declared special dividends — to be disbursed in advance of what are expected to be higher dividend taxes in 2013 — thus far in the fourth quarter, compared with an average of 31; they predict at least 20 more will be announced by year end.

Fundamentals, the Ultimate Driver of Markets, Remain Mixed

Advancing corporate earnings. U.S. corporate earnings have posted negative growth year-over-year for the third quarter with (with 490 of the S&P 500 companies reporting). This is the first quarter of negative growth since third quarter 2009, but it comes against extremely challenging comparisons.

Broadening manufacturing. U.S. manufacturing has contracted sharply after two months of modest expansion. According to one respondent (Fabricated Metal Products) to the Institute for Supply Management's monthly Report on Business survey, "The fiscal cliff is the big worry right now. We will not look toward any type of expansion until this is addressed; if the program that is put in place is more taxes and big spending cuts — which will push us toward recession — forget it."

Consumer strength mixed. U.S. automobile sales surged in November to a four-and-a-half-year high. The auto industry has been gradually recovering since the recession, when it hit a sales low of 10.4 million cars.

Figure 2: Fiscal Cliff Changes

Tax law	Current 2012	As of January 1, 2013
Payroll tax rate	4.20%	6.20%
Individual income tax rates	Six income brackets: 10-35%	Five income brackets: 15-39.6%
Alternative Minimum Tax (AMT)	AMT patch exempts income < $74,450	AMT patch expires and exemption reverts to $48,450
Dividends tax rate	Taxed as capital gains: 15%	Taxed as ordinary income: top rate could be 43.4%
Capital gains tax rates	15%	20%
Marriage tax	2X standard deduction for an unmarried individual filing a single return.	1.67X of single deduction rather than 2X
Exemptions	Full annual exemption amounts regardless of income	Personal exemption phaseout
Itemized deductions	Not limited regardless of taxpayer income	Itemized deductions reduced by 3% of adjusted gross income over threshold
Child tax credit	$1,000	$500
Child and dependent care tax credit	$3,000 for one child and $6,000 for two or more dependents	Maximum of $2,400 for one child and $4,800 for two or more dependents
Sequestration	Simpson-Bowles plan cuts $4 trillion over ten years (failed to pass)	$4 trillion in spending cuts over ten years (~$500 billion in 2013) including a 10% reduction in defense
Estate tax	Exemption of $5.12 million; 35% rate	Exemption of $1 million; 55% rate

Source: ING U.S Investment Management

This year the industry is on track to achieve sales of 14.5 million units. Consumer confidence, which just reached a three-year high, is the main reason for the automobile sector's resurgence. But the solid housing rebound is also lifting sales, as are ultra-low auto loan rates and pent-up demand for cars and trucks as recession-weary consumers have kept their aging vehicles longer than usual.

Developing economies. Speaking of automobiles, several major car makers have recently announced expansions in Mexico. With its strong manufacturing base, Mexico is one Latin American economy that continues to post robust growth statistics despite the global slowdown. Mexico's economy grew 4.2% in the first nine months of 2012 compared to the same period in 2011, and Mexico's growth prospects are not expected to dry up any time soon. Based on labor rates, logistics and currency fluctuations, Mexico has become the cheapest place in the world — less expensive even than China, India and Vietnam — to manufacture goods intended for sale in the United States. So don't be surprised if "Hecho en Mexico" becomes the new "Made in China".

Christmas Rally or Lumps of Coal for Markets?

Notwithstanding the severe challenges ahead, we expect a Christmas market rally based on more central bank action and cosmetic changes to the fiscal cliff. In particular, the Federal Reserve is likely to announce that Operation Twist — the $45 billion per month of long-term Treasury purchases/short-term Treasury sales that are scheduled to expire on December 31 — will simply be added to QE3. Meanwhile, the markets will applaud any attempts to "kick the can" down the road, no matter how short-sighted.

Politics are folly to forecast, and markets ultimately follow the fundamentals. Given the mixed signals we have been getting from the global economy, we are surprised by the relative placidity markets have exhibited in recent weeks. ■