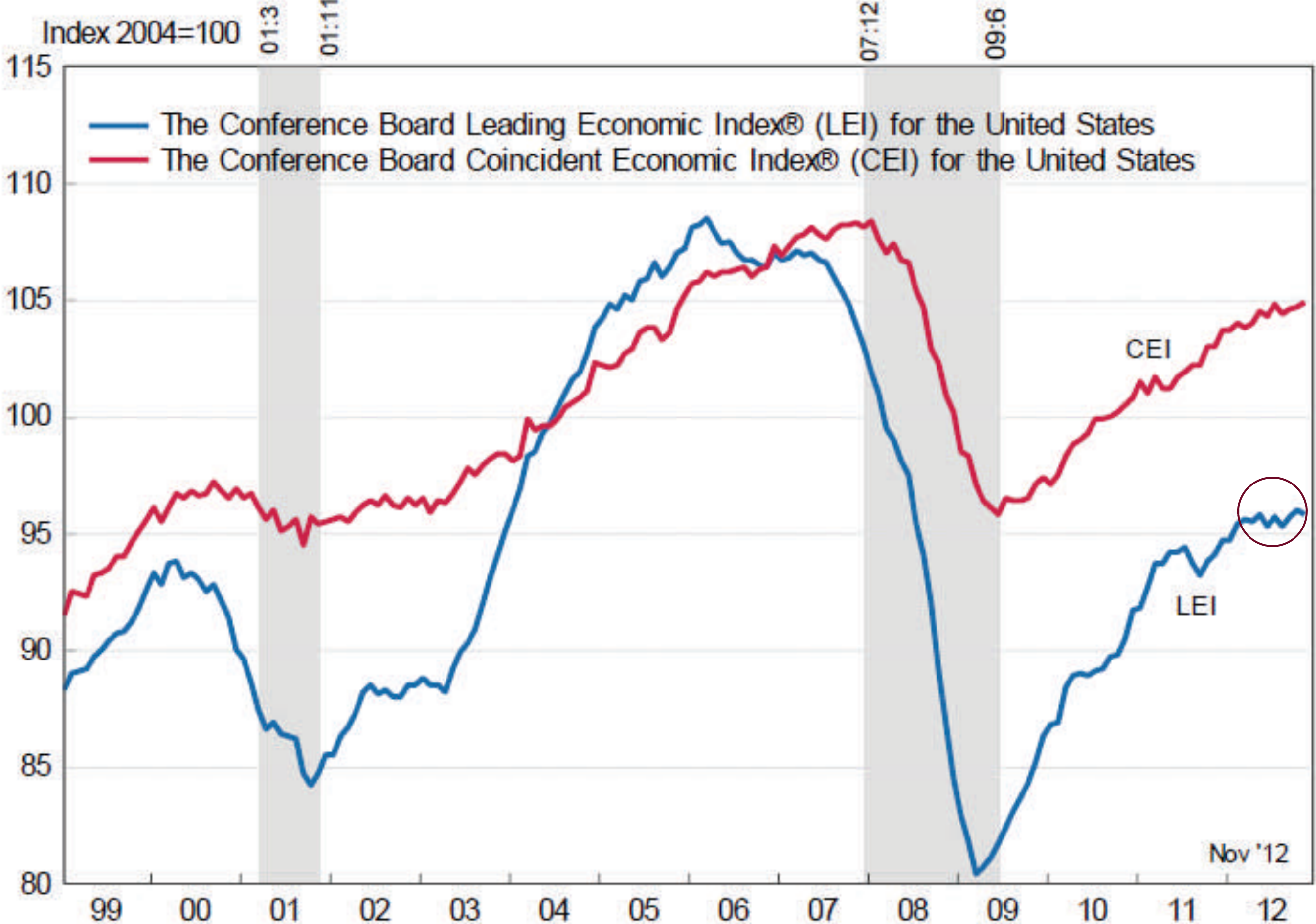
STILL A FAN OF STOCKS FOR THE LONG HAUL, BUT ...

FISCAL UNCERTAINTY SEEMS TO HAVE TAKEN A TOLL

Political wrangling over the shape of the tax code, the extent to which federal spending will be reduced, and whether Congress will allow the debt ceiling to accommodate spending levels that Congress has already approved has unnerved investors and business leaders. The fact that these issues must be addressed in a relatively short time frame may further exacerbate the general level of angst. The recent tapering off of The Conference Board's Leading Economic Index® suggests that this angst is negatively impacting the U.S. economy.



The chart on the following page, published by the Institute for Supply Management, provides a simplified glimpse of the relative health of the various components of the U.S. manufacturing effort. Instead of having to interpret each statistic according to its own set of rules, each of the statistics

appearing in the following chart has been common-sized to a simplified, 100-point scale to allow relative trends to become more apparent. The various components of this report are mostly positive and, despite persistent Congressional inaction, the U.S. economy has continued to grow in December on an overall basis. In fact, the U.S. economy has now expanded for 43 consecutive months.

MANUFACTURING AT A GLANCE
DECEMBER 2012

Index	Series Index Dec	Series Index Nov	Percentage Point Change	Direction	Rate of Change	Trend* (Months)
PMI™	50.7	49.5	+1.2	Growing	From Contracting	1
New Orders	50.3	50.3	0.0	Growing	Same	4
Production	52.6	53.7	-1.1	Growing	Slower	3
Employment	52.7	48.4	+4.3	Growing	From Contracting	1
Supplier Deliveries	54.7	50.3	+4.4	Slowing	Faster	2
Inventories	43.0	45.0	-2.0	Contracting	Faster	2
Customers' Inventories	47.0	42.5	+4.5	Too Low	Slower	13
Prices	55.5	52.5	+3.0	Increasing	Faster	5
Backlog of Orders	48.5	41.0	+7.5	Contracting	Slower	9
Exports	51.5	47.0	+4.5	Growing	From Contracting	1
Imports	51.5	48.0	+3.5	Growing	From Contracting	1
OVERALL ECONOMY				Growing	Faster	43
Manufacturing Sector				Growing	From Contracting	1

*Number of months moving in current direction.

The Institute of Supply Management has studied the relationship between various PMI readings and the growth rate of economic output as measured by gross domestic product (GDP), and its sense is that the latest PMI reading of 50.7 percent might result in real GDP growth during 2013 of around 2.7%. That sounds pretty good to my ear, but there have been some negative signals, and it would be foolhardy to ignore other important forces we know are in play such as the implications of the recent tax legislation and forthcoming spending cuts.

U.S. ECONOMY REMAINS FRAGILE

The fact that the U.S. economy has been expanding recently does not necessarily imply that it will continue to do so. Recent data for construction spending, initial jobless claims and employment, and factory orders were all either worse than consensus estimates, or contracting outright. Corporate earnings guidance released during the final quarter of 2012 has been, on balance, negative and has continued to be negative during the first few days of 2013. Revisions to analysts' earnings estimates have also tended to be negative. I'll dicuss corporate earnings more fully later, but it's hard to see how continued political wrangling over important fiscal issues could bode well for borrowing, spending, hiring, and economic growth, at least in the near term.

According to economist Ataman Ozyildirim of The Conference Board, the slight decrease in the Index of Leading Economic Indicators in November brought its six-month growth rate to zero. He adds, "The LEI points to increasing risks of slowing economic activity in the near term, but the coincident economic index, measuring current conditions, continued to increase in November. Gains in the residential construction and financial components of the LEI have been roughly balanced with weak consumer expectations, manufacturing new orders, and labor market indicators over the last six months."

Ken Goldstein, another economist at The Conference Board, adds, "The indicators reflect an economy that remains weak in the face of strong domestic and international headwinds as it faces a looming fiscal cliff. Growth will likely be slow through the early months of 2013."

ANOTHER WET BLANKET — FULLY REINSTATED SOCIAL SECURITY TAXES

For the past couple of years, mandatory employee contributions to the social security system have been reduced from a maximum of 6.2% of pay to 4.2%. Since most workers' net pay is somewhat less than their gross pay, this boost in discretionary spending power actually amounted to somewhat more than 2% or workers' pay. The legislative intent of this reduction was to stimulate the economy by temporarily boosting consumers' ability to spend (at the expense of the Social Security system). The American Taxpayer Relief Act of 2012 (the one that became law in 2013) reversed this temporary stimulation. This reversal will be felt as a contractionary economic force as will the higher tax rates that are now being imposed on higher income people.

CONTRACTION THROUGH HIGHER TAXES AND LOWER SPENDING

The American Taxpayer Relief Act of 2012 addressed the tax portion of the fiscal cliff and provided Congress with a bit more time to address the automatic spending cuts called for by the Budget Control Act of 2011. Based on the legislation that was passed earlier this month, the Congressional Budget Office now projects an 8.13% increase in revenues along with a 1.15% *increase* (no typo there) in spending for fiscal year 2013. The CBO expects this 8% increase in tax revenues to result in a $157 billion decline in the federal deficit for 2013 rather than the $487 billion decline that would have occurred if the recent legislation had not been passed.

For its part, the Federal Reserve is remaining "accommodative" which is code-speak for "foot on the gas." Nonetheless, it is important to understand that the Federal Reserve is not likely to stay in stimulation mode forever. At some point, spending will have to come under control. If Congress can't find the courage to reign in spending (and borrowing), creditor nations will reign it in for us the same way they imposed discipline on Europe ... by demanding higher interest rates on public debt. If Congress is not able to reach a spending agreement in the next couple of months, the automatic spending cuts that were temporarily deferred by the most recent legislation will once again be imposed. And remember, even if the U.S. were to go over the fiscal cliff and face the austere spending cuts that have been temporarily deferred, the U.S. would *still* face a budget deficit that would increase its already burdensome national debt. Whether legislators decide to take heavy fiscal medicine now or later, the U.S. faces a substantial debt problem.

GARDENER'S DILEMMA

Of course, one can't listen to the news and not have at least some awareness of the fiscal issues that face this country. What may be less obvious is the impact on the capital markets. The bottom line for investors is that when spending is removed from an economic system, it creates a vacuum. Companies have a harder time maintaining their earnings, let alone increasing them.

Excising chunks of activity from an economy is not very different from trying to water too many plants with too little water. Since the gardener must necessarily decide how best to apportion an inadequate volume of water across those plants, his gardening decisions then become a matter of damage control. Whether the U.S. faces the economic equivalent of this dilemma soon or later, it seems certain to happen and the social and investment consequences seem to be unambiguously negative.

STOCKS PRICES SEEM FAIR ENOUGH ...

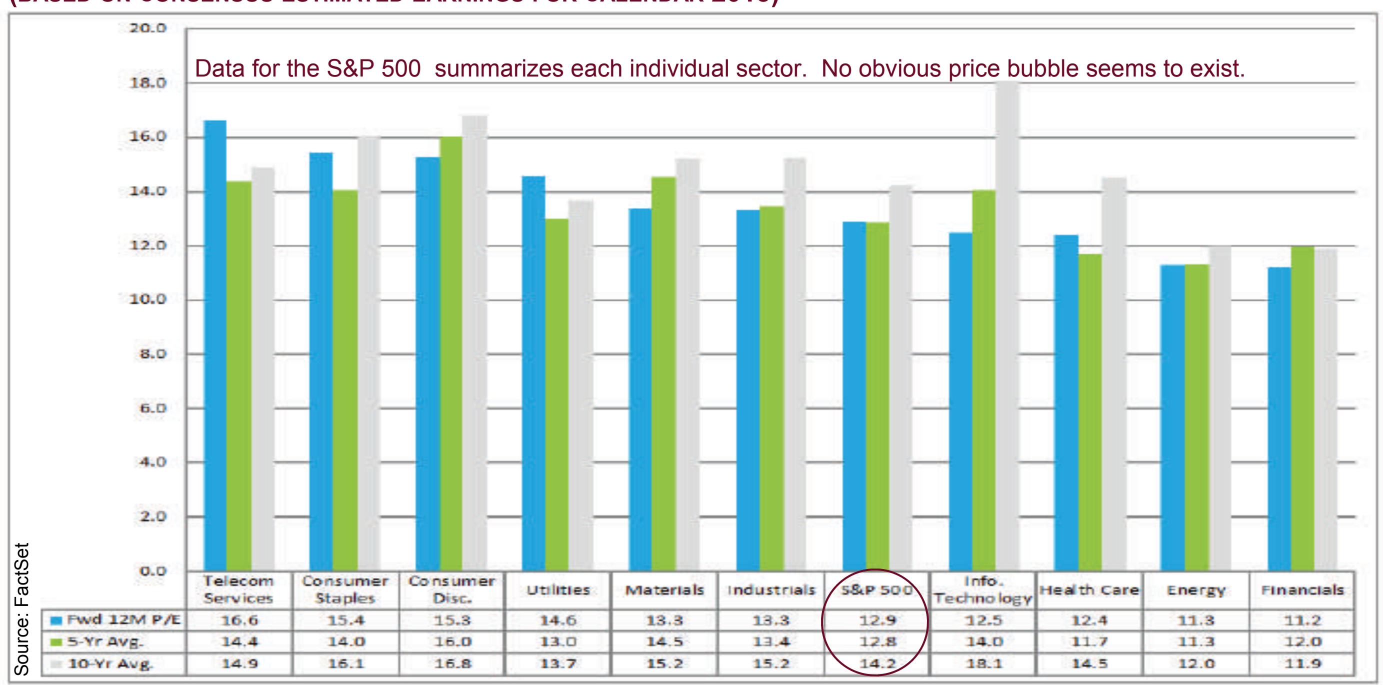
No one can definitively say whether stock prices are fairly valued since the notion of "fair" is a subjective one that depends upon a large number of factors that are always in flux. Nonetheless, it can be instructive to compare current valuation levels to historical levels. Since many investors relate the value of a stock to the cash flow accorded to one share of that stock and since cash flows are highly correlated with earnings, it makes sense to compare current stock prices to their pro rata share of earnings. An unscientific reading of the upper chart on the following page suggests that current stock prices are within the range of normalcy. The chart beneath it suggests that analysts expect earnings to grow modestly well during 2013, too. On the face of it, this is decently good news.

... BUT EARNINGS ESTIMATES ARE FALLING

Unfortunately, analysts have recently begun to reduce their 2013 earnings estimates as shown in the upper portion of the chart on page seven. Although analysts have historically tended to be overly optimistic when releasing their earnings estimates, subsequent downward revisions have tended to be followed by an actual decline in earnings.

RATIO OF STOCK PRICE TO EARNINGS PER SHARE OF STOCK — BY SECTOR

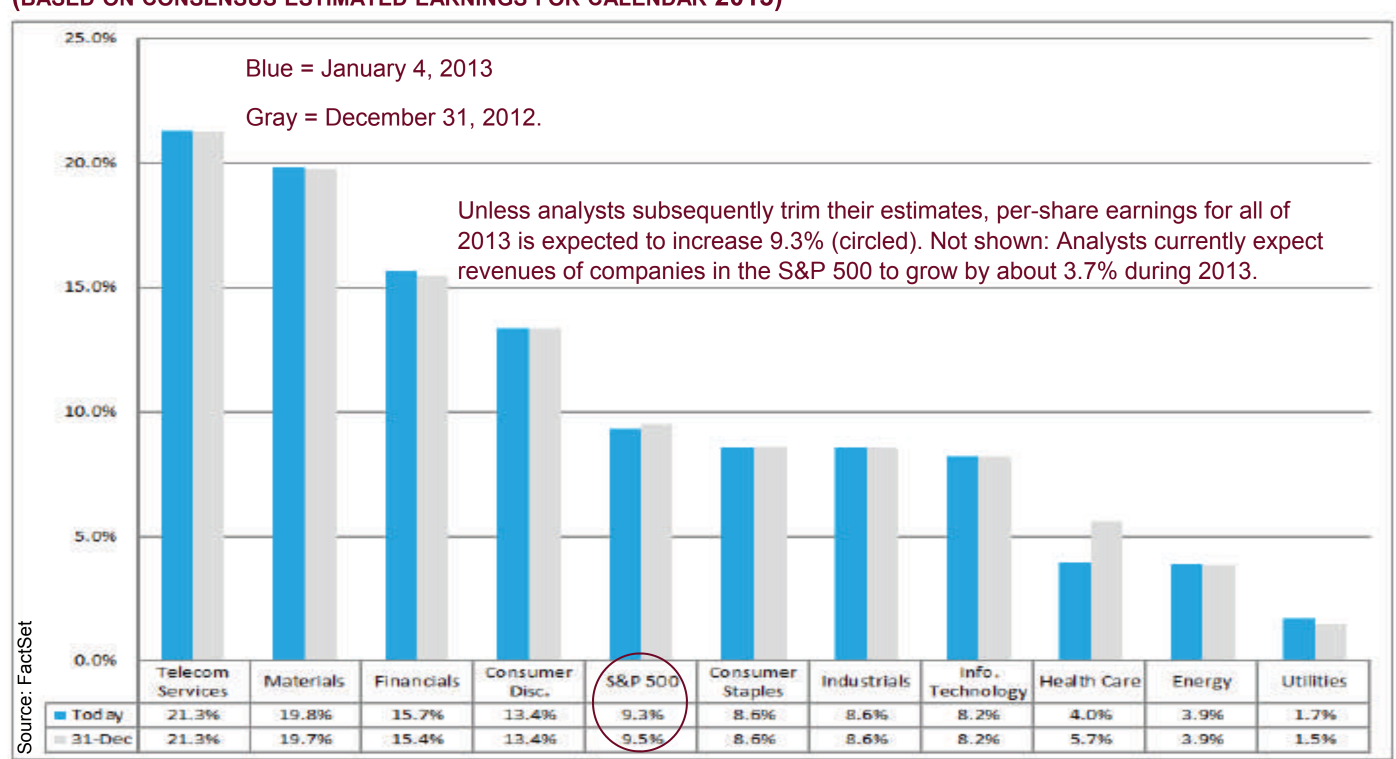
(BASED ON CONSENSUS ESTIMATED EARNINGS FOR CALENDAR 2013)



	Telecom Services	Consumer Staples	Consumer Disc.	Utilities	Materials	Industrials	S&P 500	Info. Technology	Health Care	Energy	Financials
Fwd 12M P/E	16.6	15.4	15.3	14.6	13.3	13.3	12.9	12.5	12.4	11.3	11.2
5-Yr Avg.	14.4	14.0	16.0	13.0	14.5	13.4	12.8	14.0	11.7	11.3	12.0
10-Yr Avg.	14.9	16.1	16.8	13.7	15.2	15.2	14.2	18.1	14.5	12.0	11.9

EXPECTED GROWTH OF PER-SHARE EARNINGS — BY SECTOR

(BASED ON CONSENSUS ESTIMATED EARNINGS FOR CALENDAR 2013)



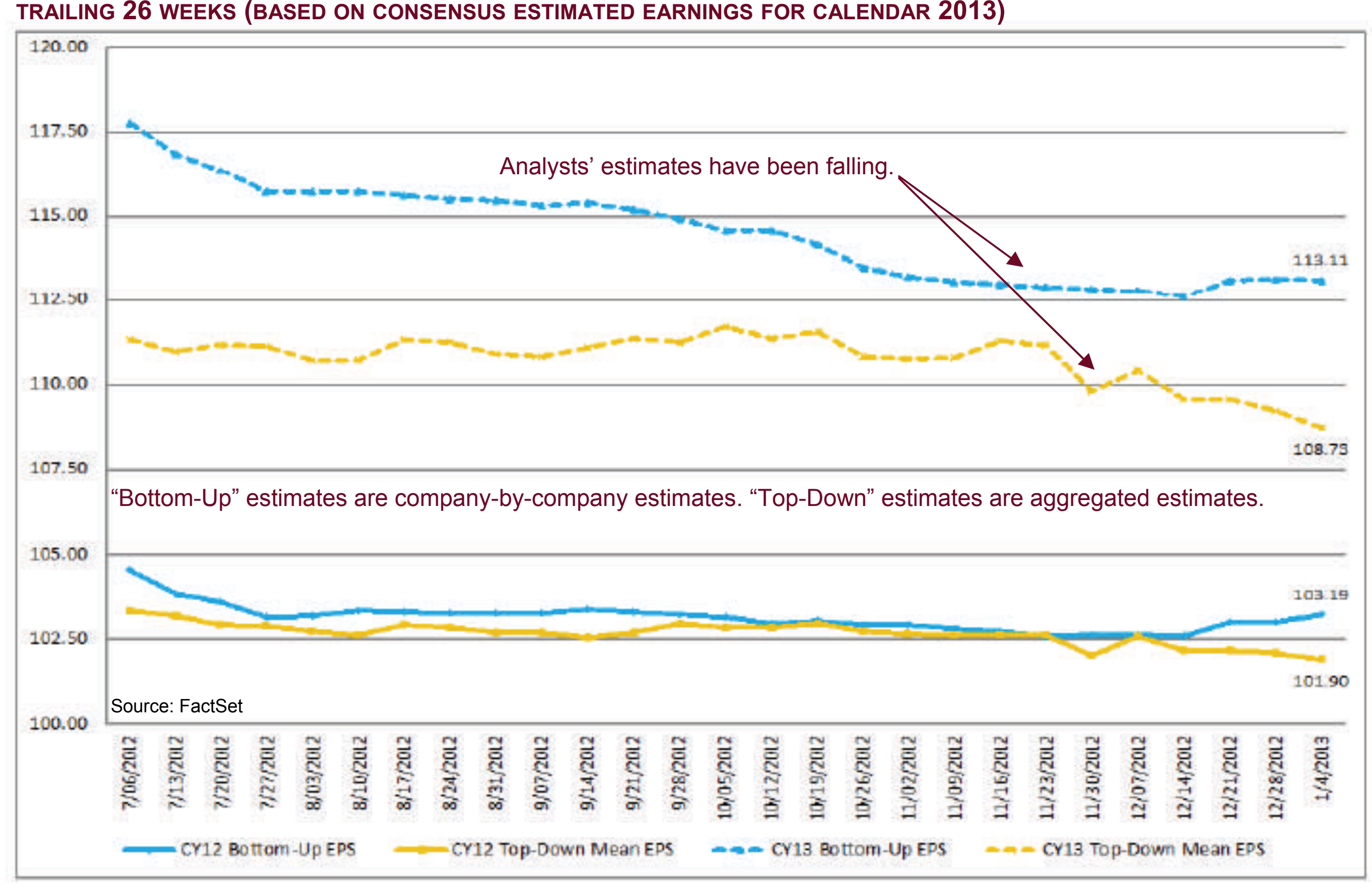
	Telecom Services	Materials	Financials	Consumer Disc.	S&P 500	Consumer Staples	Industrials	Info. Technology	Health Care	Energy	Utilities
Today	21.3%	19.8%	15.7%	13.4%	9.3%	8.6%	8.6%	8.2%	4.0%	3.9%	1.7%
31-Dec	21.3%	19.7%	15.4%	13.4%	9.5%	8.6%	8.6%	8.2%	5.7%	3.9%	1.5%

Since last September, analysts have cut their earnings estimates for seven of the ten sectors that comprise the S&P 500. Expectations of earnings growth for the first quarter of 2013 have fallen from 5.3% to 2.5%. Similarly, expectations for the second quarter have fallen from 9.1% to 6.7%. (For both quarters, the materials and information technology sectors have been downgraded the most.)

Of the 110 companies that have issued revised earnings guidance for the 4th quarter of 2012, over 70% of the these revisions have been negative. Through January 4th of this year, eight additional companies have revised their earnings guidance for the first quarter of 2013 and all but one has been negative. While analysts have tended to be optimistic when making initial earnings estimates, subsequent downward revisions have often been followed by actual earnings declines. To the extent analysts are correct and to the extent corporate earnings continue to drive stock prices, these recent downward revisions are of concern.

CALENDAR YEAR 2013 REVISIONS OF PER-SHARE EARNINGS ESTIMATES

TRAILING 26 WEEKS (BASED ON CONSENSUS ESTIMATED EARNINGS FOR CALENDAR 2013)



GLOBAL GROWTH SUBSIDING TOO

Economic growth in emerging countries has also been decreasing over the past year. According to FactSet Economics, the annual rate of economic growth in China, India, and Brazil during the first nine months of 2011 was 9.1%, 6.9% and 2.1%, respectively. During the first nine months of 2012, these respective rates had fallen to 7.4%, 2.8% and 0.9%.

Here's a glimpse of the GDP growth rates of some of the major developed economies. The "LAST column displays GDP growth in the third quarter of 2012 while the "PREVIOUS" column represents the second quarter of 2012. Perhaps, the thumbnail charts on the far right-hand side of this chart best capture the stagnation of these economies.

LARGEST ECONOMIES	LAST	PREVIOUS	HIGHEST	LOWEST	UNIT	REFERENCE	FREQUENCY	CHART
UNITED STATES	2.60	2.10	13.40	-4.60	Percent	Sep/2012	Quarterly	
EURO AREA	-0.60	-0.40	5.00	-5.20	Percent	Sep/2012	Quarterly	
CHINA	7.40	7.60	14.20	3.80	Percent	Sep/2012	Quarterly	
JAPAN	0.50	3.90	9.40	-9.40	Percent	Sep/2012	Quarterly	
GERMANY	0.40	0.50	4.70	-6.80	Percent	Sep/2012	Quarterly	

FINAL THOUGHT

None of the foregoing is intended to suggest that stock prices can't advance during 2013. They certainly can, especially since the Federal Reserve has indicated it will remain "accomodative" until the unemployment rate falls another percent, or so. History suggests that it's unwise to fight the Fed and, for the most part, I share that sentiment. In fact, many forecasters believe that after a breather in the first half of 2013, economic growth will reaccelerate.

Regardless of whether the slowdown that now seems to be settling upon us materializes further, and regardless of whether economic growth throughout the world does, in fact, begin to reaccelerate in the second half of 2013, I remain strongly convinced that common stock dividends offer investors the best prospects of a rising income. Nonetheless, I am inclined to remain somewhat cautious for the time being.

— Glenn Wessel