

Economic Forecast 2013

Dancing on the Edge of the Cliff

Speech by Bosworth Todd before the Louisville Rotary Club
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Dodging the Iceberg, But Still Adrift

The fiscal cliff odyssey produced no long run budget fix, leaves the door wide open for another debt ceiling fiasco in a matter of weeks, and installed a new “mini-cliff” for government spending in two months. But the deal, agreed to at the last moment, lessens the risk of the worst case scenario of a recession-inducing fiscal shock. And it permanently extends many tax rates that, for a decade, required recurrent legislative renewal, the Alternative Minimum Tax, for example. No wonder the Dow rose 304 points, the biggest jump in a year.

We still face significant fiscal drag in 2013, as most Americans will receive a tax increase. The Social Security payroll tax cut, which was 2%, will lapse. This is a \$126 billion tax increase on all wage earners. Income taxes will rise for the top 2% – the first income tax increase in 20 years, affecting couples making \$450,000 or \$400,000 for individuals.

The estate tax, currently 35% with a \$5 million exemption was scheduled to go to a 55% rate with only a \$1 million exemption. I am relieved it will be a 40% rate with a \$5 million exemption and is indexed for inflation.

The deal produced no net impact on our 2013 economic forecasts. We still expect 2% real GDP growth in 2013. Fiscal drags should essentially counteract improving fundamentals in housing, the labor market, and consumer spending.

Structural budget issues, particularly entitlement spending, were side-stepped in the debate. And so the long-run fiscal trajectory of the federal budget remains on an explosive path. All this dithering is frustrating to me because we have 23 million people out of work or underemployed three and a half years after the worst recession in over 60 years. Obama now has a second chance to show he is not only the best campaigner in a generation but also an effective president. How he handles this “fiscal cliff” from here will set the tone for the next four years.

Gillian Tett, of the Financial Times, my guru, says we can expect a lot of “cliff dancing,” tip-toeing back and forth from disaster with a series of delaying tactics, thus kicking the can down the road once again. Instead of compromising with a grand bargain, like Bowles-Simpson, she thinks we will just get sluggish growth in 2013 plus a volatile market in the first quarter.

Over the last five years the Bank of England, the Federal Reserve and the European Central Bank have embarked upon significant stimulus through expanding their balance sheets by printing money. It's obviously been supportive for the equity markets. It can't go on forever, but it's wonderful while it lasts.

I believe stocks will prevail because interest rates are extremely low and I find plenty of blue chip stocks that yield 3% more and grow at least 6-8% a year.

Bernanke said he was going to keep interest rates low until the employment data improves significantly. The interest rate on a new car loan or a 15 year mortgage is only 3.0%.

Fed Alters Relationship between Stocks and Bonds

David Rosenberg, former chief economist at Merrill Lynch, reminds us that not long ago it was the economy that drove asset prices, such as stocks and bonds. Today it is the reverse, with asset prices driving the economy. There was a time when the Fed cut short-term interest rates to low levels for a brief period of time when it wanted to stimulate the economy and stir investor animal spirits. But those rates have been almost zero for four years. The Fed is completely altering the relationship between stocks and bonds by nurturing an environment of low interest rates not even coming close to offsetting inflation. Most maturities of government bonds yield 1% or less, and inflation is over 2%. However, profits on the S & P stock index are strong. There is no question the Fed can influence asset prices and it will continue this intervention until the unemployment rate gets much lower. Investors remain cautious. For me the answer is common stocks, with a focus on dividend growth, dividend yield, and a strong balance sheet.

History suggests only two or three more years of flat markets lie ahead. A chart of the Dow Jones average, going back to 1900, suggests four flat markets, lasting about 15 or 16 years, followed by a bull market. This current flat period started in 1999, 13 years ago, when the stock market first reached its current level.

With respect to bonds it is a nightmare for the saver but a joy to those that need to borrow money. Money market yields are practically nothing and you have to go out 10 years on Treasuries to get a 1.7% yield. Normally one expects to get about 4.0%.

Constant Use of Military Power Will Wane

I want to digress a moment about defense spending. Military spending will wane. In early November George Friedman, of Stratfor Research, wrote an interesting memo on foreign policy, which I will summarize.

“The US emerged as the only global power in 1991 when the Soviet Union fell. We remain so despite costly wars with Iraq and Afghanistan. Disintegration in Europe and financial crisis in China means we remain the unchallenged global power. Constant use of military power is not an option. Our mistake was inserting insufficient force to defeat an enemy that could be managed by other means, and whose ability to harm us was limited. The last gasp was Lybia, out of control before Benghazi...thus insufficient force against an uncertain enemy of little importance.

We cannot be the global cop. We must pursue our own interest at the lowest possible cost even though we are 25% of the global GDP. We should have a ruthless indifference to things that don't matter that much to us. If it does matter then we should go all out.

Don't Follow the Crowd

Don't panic over transitory news. Stick to your plan. Too many investors succumb to emotions and sell low and buy high. Year in and year out three fourths of all mutual fund investors fail to meet their benchmarks. One should prevent emotion from overtaking reason. Market timing seldom works.

Remember it was Disraeli, who once said: “what we anticipate seldom occurs, and what we least expect generally happens.”

The stock market, in the last five years, has absorbed the shock of ½ billion dollars of net redemption of stock mutual funds, in contrast to over \$1 billion pouring into bond funds. Over the last 5 years stock funds returned 1.2% while bond funds returned 5.9%. However, in the past 12 months stock funds returned 16% while bond funds returned 5.3%.

According to the Economist the average hedge fund returned only 3% over the past year. The S&P 500 has now outperformed the average hedge fund for ten straight years, with the exception of 2008 when both fell sharply.

How Did My Forecasts Pan Out?

I was wrong on four of nine forecasts, oil, unemployment, the Euro and the S&P. I was close in 2012 on my real GDP growth forecast of 2%. It was 2.2%. Our economic growth will not return to the pre-crisis rate of 3% this year. Dancing on the Fiscal Cliff and weak export demand will hold us to a 2% rate, another disappointing year of recovery...the fourth in a row. Relative to

Europe, we will continue to be a bright spot. I had earnings on the S&P 500 up 5% to \$101. It was up 7% to 103. I look for only a 2% gain this year. I expected inflation to be 2%. It looks like it was 2.1% I am staying with 2% this year. I expected no change in interest rates with my forecast of the 10 year Treasury bond staying at 1.9%. It fell to 1.7%, I look for rates to rise slightly to 2.1% this year. I thought gold prices would rise 10% to \$1725. They rose 6% to 1660. I'll guess \$1700 for 2013. I had the direction right but was too timid on the stock market. It was up a surprising 13% to 1405. My forecast was only for a 5% rise. I look for a 5% market gain this year.

The European currency stayed at \$1.32 vs. the dollar. I thought it would weaken to \$1.24. I was also wrong on oil prices which I thought would rise 10% to \$110 per barrel. Instead it fell 11% to \$89. I expect it to rise about 7% to \$95. I was also wrong on the size of the drop in unemployment. I thought it would drop slightly from 8.6% to 8.3%. It fell to 7.7%. I look for 7.5% this year.

My Six Stock Picks

I still like to have a global portfolio with an emphasis on dividend yield. There is nothing like a good portfolio with a dividend yield to quiet the nerves in a fragile economy. I prefer a portfolio of stocks with a global, not just domestically focused, emphasis to take advantage of growth opportunities in emerging countries.

Thus three of my six stock picks are foreign and their overall dividend yield is 4.9%: It includes three carry-overs.

Shaw Communications [SJR \$22.63] a Canadian cable and satellite TV operator has a steady 7% earnings growth, sells at 13x earnings, and yields 4.5%. We like the outlook for our neighbors to the North.

Philip Morris International [PM \$83.00] This is a carry-over stock from previous years. I like the 4% yield and steady earnings growth, all derived from abroad. Earnings should continue to grow, on a per share basis, about 10% a year.

Microsoft [MSFT \$27.00] with its 3.5% yield, 10% earnings growth and AAA balance sheet, is another holdover and one of the most under-appreciated stocks on my list. In 2012 the company introduced Windows 8, its new operating system, which received favorable reviews. It partnered with Nokia in introducing Windows to the Smartphone market and second, it introduced its first computer, the Surface tablet. Both products have been well received in these two huge markets.

Pfizer [PFE \$25.00] This leading drug stock is 11 times earnings and yields 3.8%. Foreign earnings are 60% of the total. It is recovering nicely from its patent cliff with a pipeline of new products.

Seadrill [SDRL \$36.50] This Norwegian company provides contract drilling internationally through a modern fleet of offshore drilling units. Its chief appeal is its 9.4% yield. It typically pays out all its earnings.

McDonalds [MCD \$87.50] This carryover stock declined 13% last year reflecting a disappointing 1% gain in earnings. The dividend was just increased 10%, giving it a 3.5% yield. We believe the current slowdown in earnings is temporary. Foreign earnings are 57% of the total.

One Final Note

“It’s not the strongest species that survive, not the most intelligent but the ones most responsive to change.” –Charles Darwin

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