U.S. Economy Nears Precipice of Fiscal Cliff

**MARKET SUMMARY**

- Congressional debate of the “Fiscal Cliff” issue will dominate U.S. economic news in the near term.
- If fiscal compromise is reached, improved consumer balance sheets, a healthier housing market, and an extremely accommodative Federal Reserve policy could support a gradually improving economy in 2013.
- The U.S. jobs picture brightens, but more rapid growth is needed to put a meaningful dent in the 7.9% unemployment rate — a key issue during the presidential election campaign.
- The Eurozone and peripheral countries have gained some stability, but flare-ups of debt burdens still threaten. Global economic slowdown is still a concern.
- Interest rates are likely to remain relatively low longer than most investors expect.
- Despite uncertainty, we are maintaining our overweight position in stocks.

**INTRODUCTION**

By now most of us have grown weary of hearing the words “Fiscal Cliff” — the mandated tax hikes and spending cuts that are set to kick in on January 2nd unless Congress and the White House can authorize a deal. But as of this writing, there has been no resolution. Accordingly, the looming cliff is at the forefront of most investor-related concerns and is already affecting business confidence. In fact, we have seen large swings in the market indices based on the daily comments from our politicians on the progress of the negotiations — or lack thereof. To prevent a potential recession caused by excessive fiscal contraction, some compromise on revenue, spending and entitlement reform must occur. If a credible deal is reached in the next couple of months with no major tax increase and no large, across-the-board near-term spending cuts (which is our expectation), 2013 could start on an encouraging note. In the meantime, fears about policy gridlock and associated growth implications are the main source of shorter-term risks to next year’s outlook.

**Aside from the Fiscal Cliff** and other geopolitical wild-cards, we expect a moderately better economy in 2013. As we will discuss below, improved consumer balance sheets, a healthier housing market, an extremely accommodative Federal Reserve policy (as well as easing programs around the world) will help offset federal government austerity. In addition, an upturn in the global manufacturing cycle, combined with subdued domestic energy prices and a generally stable dollar should support a gradually improving economy.

**ECONOMIC OUTLOOK**

The U.S. economy has had trouble gaining traction. As mentioned in our previous Outlook publications, the economy has been dealing with

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Given the considerable economic slack and corresponding low inflation expectations, inflation should remain well-contained (near 2%). (CHART 2) This, combined with a stubbornly high unemployment rate, provides the Fed with latitude to stay with an exceptionally accommodative monetary policy for an extended period. In September the Fed announced open-ended Quantitative Easing (purchases of Mortgages and Treasuries) tied to a material improvement in the labor market. It also extended its expectation of near-zero short-term rates until mid-2015.

The sluggish job market has been an ongoing trouble-spot in the recovery since the great recession of 2008-09. Even though the economy has generated 4.6 million jobs since February 2010, we lost 8.8 million during the recession. (CHART 3) It will likely take three to five years of growth to get employment levels back to their prior peak and even longer to drive unemployment down to acceptable levels. Fortunately, the jobs picture has recently brightened somewhat. Job growth has now averaged 168,000 a month for the last five months, a much better showing than during the spring when payrolls sputtered. Still, job growth of this magnitude will not drive the unemployment rate materially lower.

Among the brighter spots domestically is the ongoing improvement in the housing and auto sectors. Housing market indicators continue to strengthen as the housing recovery takes shape. House prices and home sales (new and existing) have been moving up, (CHART 4) and the National Association of Home Builders market index for single-family sales has been consistently rising over the past year, pointing toward continuing recovery in the housing sector.
Auto sales have been helped by a rebound from vehicle damage caused by Hurricane Sandy as well as the need to replace aging vehicles. This put the industry on pace for a near five-year high, approaching an annual rate of 15 million vehicles, which would mark the highest level since February 2008. So both vehicle sales and the improving housing market are encouraging spots and are expected to help boost the economy heading into 2013.

A yet unresolved issue is the ongoing Eurozone crisis. However, the recent progress in containing the problems marks an important difference compared with last year. European Central Bank (ECB) President Draghi has made it clearer than before that the ECB will “do what it takes” to protect the survival of the Euro. The framework that is supposed to govern ECB intervention (purchases) of the peripheral government bond markets is still untested, and many implementation questions remain amidst a poor economic outlook for the peripheral countries. But we are now more optimistic that Mr. Draghi’s pledge has reduced the risk of financial instability and spillover to the United States and Asia.

So in summary, assuming that a fiscal compromise is reached, our expectation is that U.S. GDP growth will be roughly 2% in the first half of 2013, which is slightly improved from the 1.7% level expected for 2012. However, it must be noted there is considerable uncertainty, and going over the full height of the cliff (net impact of 3% – 4% reduction in nominal growth) could produce zero or even negative U.S. GDP growth in the first half of next year.

From a global perspective our premise is that the world economies grow on average 3.2% in 2013. This is derived by combining the following projected growth rates: United States, 2%; Eurozone, 0%; and Emerging Markets, 6%. At the same time many issues remain unresolved overseas, as recession clouds much of Europe, growth proceeds in fits and starts in China, and tensions are now heating up in the Middle East. The impact of all of this is a wild card for 2013. Even so, the fundamentals of a slowly growing economy, low inflation and a supportive Federal Reserve (and the other major central banks) favor improvement over the intermediate term. But first, we may have to navigate through some headwinds and cross currents. In this environment, we believe a calm and orderly approach to the markets is the best path.

**FIXED INCOME**

Eurozone issues and the challenges posed by slow domestic economic growth were still present in 2012, but they impacted the bond markets to a lesser extent than in 2011. The past year was marked with declining uncertainties. The ECB announced the Outright Monetary Transactions program that helped stabilize conditions in Europe and contributed to shrinking market risk premiums. While domestically, Fed accommodations in the form of quantitative easing (QE3) and Operation Twist succeeded in keeping interest rates low for 2012.

Across the Treasury yield curve, interest rates in general were slightly lower in 2012. (CHART 5) Two-year Treasury yields were nearly unchanged for the year while the 10-year Treasury yield...
declined by 26 basis points. The relatively benign change in interest rates masked the overall volatility. Interest rates initially rose in the first part of the year and then fell sharply as concerns about a global economic slowdown took hold.

On a historic basis, Treasury yields are still extremely low with the 10-year Treasury yield not far off from its record low yield of 1.39% reached this past July. The Federal Reserve and its quantitative easing programs have helped keep rates depressed, and the Fed has pledged to keep rates low until 2015. Also, reduced risk appetites and Europe’s debt crisis have kept a steady investor demand for U.S. Treasuries.

In search of additional yield, investors moved out on the risk spectrum. High Yield, Emerging Market and investment grade Corporate bond funds saw large cash inflows over the past year as zero cash rates drove bond buyers to take on more risk. With many companies paying off existing debt, there has been limited growth of bond supply. Strong demand has led to the risk premium (i.e., spreads) tightening, pushing bond prices higher and yields lower. (CHART 6) Investment grade corporate bond yields reached an all-time low of 2.73% in November, versus an average of 5.10% since 2002. Stable earnings and strong corporate balance sheets helped contribute positively to this performance.

The overall U.S. bond market, as measured by the Barclays Aggregate Bond Index, returned 4.36% year-to-date through the end of November. In a reversal from 2011, Emerging Market Debt and the High Yield bond sector were the top-performers. (CHART 7) Returns in these sectors were helped along by record low default rates. Moody’s expects the global speculative-grade default rate to end 2012 at 2.8%, nearly half its long-term average.

Improvement in the financial condition of many banks boosted the finance sector and was a big contributor to the outperformance in Corporate bonds relative to Treasuries.

Municipal bonds did exceptionally well for a second consecutive year. The Barclays Municipal Bond Index was up 8.12% year-to-date through the end of November. Despite the news of fiscal problems for a number of municipalities and several high-profile bankruptcies, there were few signs of heightened investor risk-aversion in the municipal bond market. Politicians have begun talking about taking away some of the advantage of tax-free municipal bonds. Limiting the tax deductions associated with municipal bonds would certainly make them less popular with retail investors. So far, nobody has proposed taxing all municipal interest income.

Discussion and resolution of the Fiscal Cliff will likely be the greatest influence on the bond market in the remaining weeks of 2012 and into 2013. We expect fixed income investments to produce positive returns for 2013, but likely in the low single digits. Yields should remain low as the sluggish economy provides little inflationary push. Some spread tightening is still possible, especially with High Yield. Spreads on corporate bonds are closer to historic averages, but will also likely contract, contributing to returns.

The 2012 performance for Emerging Market bonds will be a tough act to follow (+16.8% through November). The total amount of bond issuance for this sector now rivals the U.S. High Yield market. Rating upgrades are expected to exceed downgrades in the coming year. Strong investor demand should keep this sector’s return in positive territory.

As the European debt crisis diminishes and the U.S. economy shows further improvement, interest rates ultimately are expected to rise. Still, the Fed will be working diligently on trying to keep rates low. The push and pull of Fed action versus economic fundamentals will likely result also in a fairly volatile interest rate environment. Still, we expect rates to remain relatively low longer than most investors expect.

EQUITY

Equities are poised to record double-digit returns in 2012 against a backdrop of continued European financial uncertainties, a slowing Chinese economy, decelerating U.S. corporate earnings, and the approaching Fiscal Cliff in the
The S&P 500 index has decelerated from 15% in 2011 to 3% to 5% growth in 2012. Expectations are for 5% to 7% in 2013 as the international economies start to rebound. Earnings expectations have come down considerably over the last couple of months to realistic levels and as we move through 2013 expectations could be too low. The S&P 500 Operating P/E is at 14.5 times trailing earnings, well below the median of 16.1 times. As long as inflation and interest rates do not start a meaningful increase, valuation levels could actually move higher.

In a slow economic growth environment we believe domestic equities will return in the 6% to 9% range in 2013 versus 1% to 3% for fixed income and 0% for money market returns. Equities offer competitive yields to bonds and in many cases considerably higher yields than the 10-year Treasury note. Dividends also increase over time, giving investors a rising income stream to counter inflation. Over the past year dividends for the S&P 500 have increased 18.25% and we expect dividend growth to be in the 7% to 10% range in 2013.

The earnings growth rate for the S&P 500 index has decelerated from 15% in 2011 to 3% to 5% growth in 2012. Expectations are for 5% to 7% in 2013 as the international economies start to rebound. Earnings expectations have come down considerably over the last couple of months to realistic levels and as we move through 2013 expectations could be too low. The S&P 500 Operating P/E is at 14.5 times trailing earnings, well below the median of 16.1 times. As long as inflation and interest rates do not start a meaningful increase, valuation levels could actually move higher.

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ALTERNATIVE INVESTMENTS

Alternative investments include strategies in the main categories of Hedge Funds, Real Estate, and Commodities/Natural Resources/Real Assets. From a portfolio diversification standpoint, Alternative Investments may be attractive due to lower correlations to traditional asset classes of stocks and bonds. By introducing investments that behave differently from the rest of the portfolio, they can reduce portfolio risk (volatility) and potentially enhance long-term returns.

Hedge fund returns were modestly positive in 2012. The HFRI Fund of Funds Composite Index year-to-date return through October 31 was 3.05% and the HFRI Fund of Funds Conservative Index was 2.74%. Conservative hedge funds provided a cushion to portfolios as they held their value during the period of May-June as fear over the European debt crisis returned. We focus on multi-manager and multi-strategy vehicles in a mutual fund structure that offer daily liquidity, transparency, low minimums, and an attractive fee structure.

Real Estate Investment Trusts (REITs) performed strongly in 2012. The MSCI U.S. REIT Index was up 13.52% through November 30. Compared to corporate bonds and private real estate, U.S. REITs are fair to attractively priced. Compared to U.S. Equities, U.S. REITs are unattractive. The U.S. real estate market outlook is for above average cash flow growth despite a slow economy.

The looming Fiscal Cliff and how Congress will address our long-term budget deficit will also take center stage with equities over the coming months. Our equity market assumption is that a deal will be completed sometime in the first six months of 2013, but it might not be a smooth path achieving a compromise. If we look back at how stocks perform over a Presidential cycle, the worst six months over the four-year period is the first six months. The first six months seem to be the only time major legislation can be passed (Health care in 2009) before the campaigning cycle begins again for mid-term elections. Stock prices could hit a few downward air pockets over the coming months as investors sort out the effects of new legislation and the implications for the economy.

In the face of the fiscal uncertainties, we are maintaining our overweight position in stocks. Given dividend tax rates in 2013 have already been discounted, we feel stocks offer an attractive risk-adjusted return to fixed income and money market returns. Equities offer competitive yields to bonds and in many cases considerably higher yields than the 10-year Treasury note. Dividends also increase over time, giving investors a rising income stream to counter inflation. Over the past year dividends for the S&P 500 have increased 18.25% and we expect dividend growth to be in the 7% to 10% range in 2013.

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Commodity index returns were slightly positive in 2012 with the DJ UBS Commodity Index returning 1.59% through November 30. The performance of individual commodities was mixed (CHART 8) with agricultural products affected by the heat and drought of the summer. Crude oil was down 10%, and fairly stable throughout the year. An improvement in growth in the developing markets could put upward pressure on commodity prices. Gold continues to be supported by easy monetary policies and low real interest rates.

Infrastructure investing is gaining more acceptance as an asset class. Investors seeking income along with growth potential allocated more to this sector throughout the year. This is reflected in the Alerian MLP Index return of 8.15% through November 30.

CONCLUSION
Despite a year filled with uncertainty on many fronts – the outcome of Fiscal Cliff negotiations, decelerating U.S corporate earnings, unresolved issues overseas and the prospect of recession in Europe, erratic growth in China, and rising tensions in northern Africa and the Middle East – financial assets posted positive returns overall. It may be challenging for investors to navigate these winds and cross currents over the next several months. However, improving fundamentals of a slowly growing economy, low inflation, and accommodative monetary policy at home and abroad support economic improvement over the intermediate term. In this type of environment, we believe a calm, orderly, and disciplined approach to investing is the best path going forward.

INVESTMENT POLICY COMMITTEE
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