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QtrNotes

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Quotes:

Politics is not the art of the possible. It consists in choosing between the disastrous and the unpalatable.

John Kenneth Galbraith, 1969

Once a messy, short-term patch job on the leaky fiscal tire is completed, Congress and President Obama probably will spend 2-6 months contentiously hammering out a more credible deficit reduction.

Jim McTague, Barron's

Politics: A strife of interests masquerading as a contest of principles; the conduct of public affairs for private advantage.

Ambrose Bierce, 1911

In the latest survey, respondents confirmed they were better off today than a year ago, but overall confidence fell over the persistent gridlock in Washington.

Consumer Confidence Survey, The Conference Board

Fiscal Cliff Notes: Deal but No Solution

Technically, the US did go over the fiscal cliff on January 1, 2013. However, before the day was done, Congress managed to pass a permanent extension of the Bush-era tax cuts for all but the top 1% of taxpayers (individuals earning over $400,000, or $450,000 for families). It kept the country from a Wile E. Coyote plunge, but none of us considers this an actual solution to the problems. With 17 months to address the major issues and seven weeks since the election, Congress couldn't act: they merely put a Band-Aid on the immediate problem of increasing everyone's taxes and possibly triggering another recession. The thorny issues of spending cuts and entitlement reform were postponed. Everyone ran away to fight another day, when the debt limit must be raised and the two-month delay of massive budget cuts must be addressed.

Other key provisions of the bill include a permanent fix for the Alternative Minimum Tax. Taxes for all workers will go up, because the 2% payroll tax reduction was not renewed. The Unified Credit for estate taxes stays at $5 million, and the tax rate for large estates goes to 40% from the current 35%. Tax rates for capital gains and dividends return to 20% for households with incomes in excess of $450,000. In addition, the health care surtax takes effect on part of taxable unearned income (see 'New Surtax', page 2).

Index	12/31/2012	YTD
Dow Industrials	**13,104.14**	**7.3%**
S&P 500 Index	**1,426.19**	**13.4%**
Russell 2000	**849.4**	**14.6%**
MSCI EAFE	**1,604.0**	**13.5%**
Global Bond Index	**466.0**	**4.3%**
10-Year Treasury yld	**1.8%**	

Scaling the Wall of Worry

Markets often climb a wall of worry, and that was certainly the case in 2012. The US economy continued to expand, with 3rd quarter GDP up 3.1%. In November, the recovery marked its 42nd consecutive month of gains. Unemployment fell to 7.7% and is still trending lower. US manufacturing expanded, corporate profits are up across the board, and the once-flailing housing market has gained steam with new home sales up over 5% year-over-year.

Looking out on the horizon, there is reason for optimism, with the housing market growth set to continue. The other major tailwind for the US economy is the expanding energy sector. The International Energy Agency now predicts the US will surpass Russia by 2015 to become the second-largest energy producer, and will overtake Saudi Arabia by 2020. Investors can extrapolate this announcement to mean a wave of new high-paying jobs in the energy sector, coupled with lower production costs for companies in North America.

Stock markets around the world enjoyed strong and often unexpected gains in 2012, as corporate profits continued to expand on the back of an improving economic environment. It certainly helped that Europe didn't implode as some had predicted and that Greece kept the Euro. Much praise (or blame) goes to central banks around the world for maintaining stability. The European Central Bank continues to act aggressively to ensure its partner countries have sufficient liquidity to support their fragile economies, and the US Federal Reserve provided additional aid by opening short-term lines of credit to the European financial system.

Despite marked economic improvement, in the face of Congressional dysfunction, polarization, and inaction, the Federal Reserve remains committed to maintaining exceptional levels of monetary support until the recovery becomes self-supporting. This means interest rates are likely to stay pegged at zero until specific inflation or employment benchmarks are reached. (See 'Finding Income', page 2.) The unemployment target is not expected to be met until 2015, but predicting when inflation will begin to rise significantly is much more difficult. While inflation is currently just 1.8%, continued economic

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Safety in Numbers:

Tax Return Fraud

With identity theft still on the increase, tax return fraud has become a growing concern. Tax fraudsters, once in possession of valid Social Security numbers, file fraudulent returns on behalf of the taxpayers, pocketing billions in bogus refunds. The victimized taxpayers spend months waiting for their own, legitimate returns to be processed.

The stumbling point is that returns can be filed starting in mid-January, but critical information – the kind that the IRS could use to fight fraud and prevent tax return theft – is not available to the government until March.

In response, the IRS has increased some of its safeguards, but the risk remains high. Many tax specialists now recommend a proactive approach to preventing tax return theft. Filing early is the most effective means of protection: some advisors recommend filing an estimated return as soon as one can be prepared, even if an amended return must be filed later in the year once all the actual numbers are in.

If your identity has been compromised, report it to the IRS immediately to receive a PIN for use in future filing.

Scaling the Wall of Worry

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growth and money printing could quickly heat up prices on goods and services.

The long-term future for the US is bright, but the short-term landscape is much less certain. The fiscal cliff has dominated the headlines for months, and while we now know what the first draft of revenues will look like, we can't predict with accuracy what exact combination of spending cuts and entitlement reforms will ultimately tbe enacted.

The Root of the Problem

With all the discussion about spending cuts and tax hikes, what is the actual underlying issue?

The final figures are not yet in for 2012, but in 2011, US government spending was $3.6 trillion versus receipts from taxes of $2.3 trillion *(source: OMB)*. The difference is added to our accumulated debt. Although it is not problematic to have a moderate deficit in a growing economy (much as mortgage debt is acceptable for a healthy household), our deficit can't keep growing faster than our economy. If it does, we will eventually go bankrupt.

There are three ways to bring our expenditures back in line with our tax revenues: increase taxes, decrease spending, or grow the economy faster. Tax increases and spending cuts aren't pain-free, which is why there is such a focus on creating jobs and stimulating economic growth. Ideally, our elected officials will use a combination of all three.

More Room to Run?

As the S&P approaches historical highs, some investors worry that the stocks will inevitably fall. But politics aside, the markets appear to be in very good shape. Despite strong returns for 2012, valuations still look very reasonable. Corporations are producing record profits, and balance sheets are as healthy as ever.

Based on forward earnings projections, the current price/earnings ratio on the S&P 500 companies is about 12.6. The long-term average P/E ratio for the index is about 15. In theory, the market has room to grow, especially in conjunction with an improving economy. It is comforting to know that valuations are far below the 2000 peak of 25.6, as well as below the 2007 peak of 15.2, giving some reason to expect that sharp draw-downs will be limited.

Finding Income

The Federal Reserve has committed to keeping interest rates low until unemployment falls to 6.5 percent or significant inflation kicks up (over 2.5 percent). While the current low interest rate environment is unusual, it is not unprecedented. In the late 40's and early 50's, the Fed held rates very low to allow us to repay the debts from World War II.

Once interest rates finally rise, bond rates will also rise and drive bond prices down, especially on longer-maturity bonds. To deal with this, we have allocated our clients' bond positions using shorter-term, floating-rate, and globally diversified holdings to lessen the negative effects of rising interest rates.

Some people advocate using dividend-yielding stocks as a substitute for fixed income holdings. This may be a reasonable partial substitute for those who can handle the greater volatility of equities. Investors need to be aware, however, that if the economy takes a turn for the worse, bonds usually provide a better hedge against the full impact of a pullback.

New Surtax

In addition to the later-than-last-minute tax deal of January 1st, another tax change is a given: the health care legislation passed in 2011 will extend a 3.8% tax (the same as the Medicare tax on earned income) to some unearned income, including interest, dividends, capital gains, royalties and rents. The surtax will affect couples with modified adjusted gross income over $250,000 and single filers over $200,000, but will only apply to that portion of investment income that's over the threshold.

For example, roughly speaking: if, after adjustments, you and your spouse have $200k in salary and $60k in dividend income, you'll pay the additional tax on $10k of your dividends. If you have $60k in salary and $200k in dividend income, you'll still only pay the additional tax on $10k of your dividends. Or, if you have $260k in salary and $60k in dividend income, you'll pay the additional tax on all $60k of your dividends.

The surtax does not apply to non-taxable investment income, including gains within IRA and pension accounts, and interest on tax-exempt bonds.