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October 2012: Continuous Thunder

With the United States battered by storms both literal and metaphorical, voters took to the polls and cast their ballots in favor of the status quo. While the rhetoric in the immediate aftermath of the election thus far has been conciliatory, it remains to be seen whether the climate in Washington has changed enough to allow the parties to work together and avert the looming economic tempest represented by the year-end fiscal cliff.

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Corporate Caution Grows as Fiscal Cliff Approaches

As October drew to a close, Superstorm Sandy brought devastation to a large swath of the East Coast, forcing the longest weather-related shutdown of U.S. markets since 1888 and leaving area residents struggling with the loss of power, crippled public transport and gas shortages — and those were the ones fortunate enough to avoid having their homes completely destroyed. It also served as an apt symbolic bookend to another bleak election season that highlighted the divisiveness continuing to bedevil the country.

Either despite or because of the estimated $6 billion that was spent on campaigning across the country, the composition of our nation's capital remains roughly the same. President Obama retained his seat in the Oval Office by a comfortable margin, and though his fellow Democrats picked up seats in both chambers of Congress, they maintain control in only the Senate. Of course, with the day of fiscal reckoning just weeks away, there was little time for post-election celebrating or soul-searching. The latest report from the non-partisan Congressional Budget Office indicates that a stumble off the fiscal cliff — meaning a realization of the full complement of spending cuts and tax increases agreed to under last year's debt-ceiling deal — would likely trigger a recession in 2013, with economic output contracting by 0.5% and the unemployment rate spiking to 9.1%.

The uncertainty surrounding the fiscal cliff — not simply whether or not lawmakers will get their acts together by January 1, but also the many permutations of spending cuts and tax increases that may compose whatever "grand bargain" is ultimately reached — has Corporate America a bit spooked. Bank of America Merrill Lynch reported that 23% of S&P 500 companies mentioned the fiscal cliff in their third quarter earnings calls, up from only 9% during second quarter earnings season. Other changes were also afoot this latest reporting season. With 428 of the S&P 500 having reported third quarter earnings, the blended earnings growth rate stands at -0.1% according to FactSet; were this negative figure to hold, it would represent the end of the S&P 500's 11-quarter streak of earnings growth. Though earnings are forecast to return to year-over-year growth in the fourth quarter, both analysts and corporations have been taking down these numbers.

In contrast to the slowing corporate sector, consumer-related metrics have been firm. Nonfarm payrolls growth accelerated in October, and the labor force participation rate — considered a good measure of the public's confidence in the job market — increased for a second consecutive month after hitting a multi-decade low in August. Meanwhile, a variety of housing market data — everything from existing- and new-home sales and the Case-Shiller index of home values to construction spending, housing starts and building permits — continued to post new multi-year highs. Buoyed by these encouraging metrics, consumer sentiment has rebounded to pre-recession levels. And after 14 consecutive quarters of decline, household borrowing — including credit cards, mortgages and auto loans — has increased for two of the last three quarters, leading some economists to opine that consumer deleveraging may be nearing an inflection point. Retailers, for one, have bought into that way of thinking; a recent survey by BDO USA forecast a 3.7% increase in holiday same-store sales, the most optimistic projection since 2007.

Outside the U.S., the news is mixed. Though the systemic risks facing Europe appeared to have eased thanks to the efforts of the European Central Bank, the region's economy remains lifeless. The European Commission — the executive body of the European Union — slashed its 2013 growth forecast for the 17-nation euro zone to 0.1% already, down from 1.0% previously. And recent data suggest that the currency bloc likely already slipped back into recession during the third quarter. Industrial production posted its largest decline since early 2009 during September, while the purchasing managers' index compiled by Markit has floundered in contractionary territory for nine straight months. Perhaps most concerning is the

fact that the region's core economies — including Germany — are increasingly showing signs of wear. The latest readings on German industrial production and orders showed worse-than-expected declines. Meanwhile, a panel of independent economic advisors has urged Berlin to cut spending, saying that Chancellor Merkel's plans to increase social welfare spending "go in the wrong direction" given expectations for sluggish GDP growth in 2013 — which happens to be an election year.

China, in contrast, seems to be gathering momentum. Though the economy grew only 7.4% in the third quarter — its slowest rate of expansion since 2009 and below the second quarter's 7.6% result — recent data have suggested that the world's second-largest economy may finally be pulling out of its funk after nearly two years of slowing growth. Manufacturing expanded in October for the first time in three months, driven by output and new orders, while the pace of industrial production expanded. Other recent indicators, including fixed-asset investment and retail sales, have also improved. With inflation under control, Beijing's new policymakers — the country's decennial leadership change is taking place as we speak — have room to further goose the economy if necessary.

Equity Winning Streak Comes to an End

U.S. equity markets began the fourth quarter on the wrong foot, bringing an end to their summer rally. The S&P 500 Index declined 1.8% on a total-return basis in October, while the Dow Jones Industrial Average slipped 2.3% and the tech-heavy Nasdaq slid 4.4%. These bourses remain solidly positive for 2012, however, posting year-to-date returns of 14.3%, 9.6% and 15.4%, respectively. In terms of S&P 500 sectors, only two — financials and utilities — were able to deliver positive performance in October; information technology, telecommunications and materials were the biggest laggards during the month. From a size perspective, mid-cap stocks saw the least erosion, followed by large and small caps in that order. Value outperformed growth across the capitalization spectrum.

International developed markets saw greater success during the month. The MSCI EAFE Index was up 0.8%, led by the euro zone; the index has gained 7.8% for the year to date. On a local-market basis, Greece delivered outsized gains, while Austria, Italy and Portugal also outperformed the benchmark. Sweden, Norway and Singapore were among the weakest performers during October. Emerging markets gave back a portion of their strong September gains in October, as the MSCI Emerging Markets Index declined 0.7%, dragged down by Eastern Europe. Turkey, China and Colombia were among the top-performing markets, while Taiwan, Russia and India finished the month in the red.

The Search for Yield Continues

Treasury rates moved slightly higher in October across the curve, as fixed income investors continued to target higher-yielding securities. Yield on the benchmark ten-year Treasury closed the month at 1.72%, up from its end-September level of 1.65%. The widely watched Barclays U.S. Aggregate was up 0.2% in October. Treasuries trailed the index, losing 0.2%; Treasuries with maturities in excess of 20 years shed 0.1%. Risk asset classes surged, led by corporate bonds, emerging markets and high yield. Asset-backed securities and fixed-rate mortgages trailed the index. Yields on money market instruments — such as Treasury bills, short-term agency securities and high-quality commercial paper — remained very low throughout the month as the fed funds target rate traded within the 0.00–0.25% range. Libor rates were flattish.

With uncertainty regarding European and Chinese tail risks easing, the U.S. fiscal cliff is likely to be the markets' main concern. Given the apparent skepticism that a divided Washington can chart an orderly path toward the resolution of our fiscal issues, the yield curve should continue to be well-supported, perpetuating the bid for safe-haven assets and resulting in a flatter yield curve. Growth and market performance have the potential to surprise to the upside, however, should the fiscal cliff be resolved in an orderly fashion. We expect monetary policy will be kept very accommodative as fiscal restraint is delicately applied, keeping rates in a low range until private sector demand and fundamental improvements in the U.S. housing market become more sustainable.

The Standard & Poor's 500 Index is an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Nasdaq is a computerized system that facilitates trading and provides price quotations on more than 5,000 of the more actively traded over the counter stock.

The Dow Jones Industrial Average is a price-weighted average computed from the stock prices of 30 of the largest and most widely held public companies in the United States, adjusted to reflect stock splits and stock dividends.

The MSCI EAFE Index is a free float-adjusted market capitalization weighted index designed to measure developed markets' equity performance, excluding the US & Canada, for 21 countries.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that measures emerging market equity performance of 22 countries.

The Barclays Capital U.S. Aggregate Bond Index is an unmanaged widely recognized, unmanaged index of publicly issued investment grade U.S. Government, mortgage-backed, asset-backed and corporate debt securities.

The indices do not reflect fees, brokerage commissions, taxes or other expenses of investing. Investors cannot invest directly in an index.

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