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2013 Economic Forecast

Will this year be the turning point in our recovery?

The Fiscal Cliff Fiasco

President Obama has won a second-term and with it, a mandate to tax the rich and feed the poor. The Republicans' failure to take the White House primarily rests with their inability to properly address the changing demographics in our nation. Their Party remains quite fractured. The Republicans have retained control of the House of Representatives, as such, 2013 will be a year of political gridlock, conflict and chaos. Our dysfunctional government manages the nation by crisis rather than bipartisan compromise. The American Taxpayer Relief Act of 2012 became law on January 1, 2013. The basis to this Act was struck on New Year's Eve. The agreement only addresses tax reform and virtually does nothing to reduce the nation's $16.4 trillion debt or the required automatic austerity measures associated with the government's self-inflicted Fiscal Cliff crisis. We actually hit our debt ceiling on New Year's Day that will require the Treasury to employ temporary measures to run the government and prevent defaulting on payments to our creditors. The government will actually run out of money by possibly mid-March placing intense pressure on the necessity to raise the debt ceiling by the deadline of February 28th. To further exacerbate this looming crisis, the Fiscal Cliff's automatic spending cuts have been postponed until the same time. With the exception of last year's reckless absurdity, raising the debt ceiling was merely procedural and the debatable issues applied to the budget process since the inception of our nation. **Once again, the fiscally irresponsible House of Representatives will hold our economic policy hostage by threatening to force the country into default. The government should consider instituting foreclosure proceedings on the House.**

Demographics have always determined the rise and fall of both civilizations and economies. On a long-term perspective, the Fiscal Cliff looks more like an anthill when adding in our country's potential $120 trillion of unfunded liabilities consisting of the 21st-Century Social Security and Medicare Panic, uncontrollable healthcare costs and the related demographic issues associated with the retirement of 78 million baby boomers. Keynesian economic theories that have been employed since World War II, advocated that governments during periods of economic expansion should be able to set aside enough revenue in order to support the periods of downturns with fiscal stimulus. Unfortunately, the fiscally irresponsible Republican mandate to cut taxes, borrow and spend during periods of expansion have created the **Great American Debt Society.** Actually, since the birth of our country to Jimmy Carter, the national debt did not exceed $1 trillion. Our national debt, currently at $16.4 trillion, is primarily associated with the Republicans misconduct. Either way, this administration has no choice but to address our unsustainable debt trajectory. Their failure to institute meaningful austerity measures may trigger further downgrades on the US bond ratings. In the event the US loses its AAA ratings, their bonds would no longer fit the investment quality requirements of the large pension funds and endowments causing a sell-off. Although I consider this possibility remote, if this marked the end of the debt super cycle, the markets will riot, the dollar will deteriorate and interest rates would rise dramatically. When employing generally accepted accounting principles, our government is insolvent. **It is absurd to believe that the government can continue to borrow their way to future prosperity.**

Fiscal uncertainty has been the catalyst to a retrenchment in consumer spending, business investing, hiring and volatility in the markets. The prerequisite to economic expansion rests upon the demand side of the equation. In substance, credit fuels the wheels of economic activity and consumers are the drivers. The primary obstacle to economic growth has been the conflict between deleveraging and austerity measures instituted by federal, state and global governments and consumers at the same time. Against this background, fiscal restraint and raising taxes becomes counterproductive. What is needed is governmental intervention to reflate demand. This will require the postponement of short-term austerity measures and the creation of realistic long-term fiscal reform that must include curtailing entitlements and raising the retirement age given the improvement in life expectancy. President Obama, who is not facing reelection, must concede these issues. This will probably play out in the final hours of negotiations with the intent of making the Republicans appear even more irresponsible. Either way, the government will probably err on the side of caution and start instituting their austerity measures this year rather than in the future. The Fed will continue their QE program consisting of direct bond purchases for the remainder of the year. This is Bernanke's inflation injection to counter act the persistent deflationary forces infecting our economy. The Fed will do whatever is necessary to reflate demand and smooth out the business cycle in pursuit of perpetual prosperity. On the upside, it is more probable than remote that once the dust settles after February from the looming debt ceiling crisis, the constraining uncertainty will ultimately abate. At this juncture, business hiring, investing in capital goods and consumer spending will accelerate along with the stock market. **Ben Bernanke probably recognizes that the greatest obstacle to growth may very well be our own Congress.**

State of the US Economy

The US economy has demonstrated sustainable below trend growth against the backdrop of a year entrenched with uncertainties and risks. When all is tallied, GDP will average 2% that is substantially less then the prerequisite 3% necessary for meaningful job creation. The primary obstacle to growth has been the simultaneous deleveraging and austerity measures throughout the world. Our domestic fiscal uncertainty combined with recessions in Japan and most of Europe, Euro Land's sovereign debt crisis and the slowdown in the economies of China, India and Brazil were a major drag on our growth. On the upside, most of these negative growth implications are in the process of slowly reversing, which will bode well for both domestic and global expansion in 2013. Positive economic fundamentals are falling in line as follows:

- In an environment of benign inflation and excess capacity, the Fed's monetary policy will remain extremely accommodative for at least two more years.

- The banking sector is well capitalized and access to credit has continued to improve.

- The corporate sector has demonstrated strong earnings, their balance sheets are healthy and they are flush with cash.

- The consumer sector has made continued progress in deleveraging although the predominance has been through foreclosures and defaults. However, their real disposable income remains flat with little upside and their anemic wage growth has been less than inflation. On the other hand, the majority of consumers are fully employed and contrary to the general belief they are not subject to debt derailment. The new Taxpayer Relief Act will not affect 98% of all consumers. Finally, there exists an enormous amount of pent-up demand in this sector.

- The persistent unemployment is slowly unwinding ending the year with a 7.8% rate. Other than at the federal level, governmental layoffs have subsided.

- The housing sector appears to have bottomed out with prices rising and new construction accelerating. Against the backdrop of a large inventory of vacant homes, it may take many years before there is a complete recovery in this sector.

In sum, uncertainty will dissipate after the looming debt ceiling crisis is resolved, hopefully by the end of February. So long as the government addresses our unsustainable debt trajectory in a manner acceptable by the credit rating agencies, both business and consumer confidences will surge. Consumption will expand primarily with Corporate America increasing spending and hiring and to a lesser extent, spending by consumers. **This may very well prove to be the turning point of our recovery after surviving the most severe recession in post World War II history.** Absent an implosion in Euro Land and any geo-political and/or natural disasters, GDP may very well trend to 3.5% in the second half of the year. Either way, it may be two to three years before we have reached full recovery and employment. On the downside, the government’s failure to implement appropriate austerity measures may trigger a domestic and global loss of confidence in our economy and with it a possible double dip recession. **It is more probable than remote that the US economy will continue to surprise on the upside against the backdrop of improving global economic fundamentals, corporate earnings, and domestic demand.**

State of the Global Economy

The world produced dismal growth of 3% against the backdrop of the euro crisis, slowdown in China, fiscal uncertainty in the US and deflationary stagnation in Japan. On the upside, growth will accelerate as these obstacles unwind.

Although most of **Euro Land** lingers in recession, the European Central Bank (ECB), who remains committed to saving the euro, continues to make progress in reversing the crisis. The ECB has become the lender of last resort that also prevented bank failures. They will employ QE and purchase members bonds in order to cap interest rates that will ultimately give some relief to their sovereign debt issues. Finally, the EU members need to find and legislate solutions to their structural fiscal imbalances associated with the enormous disparity in their economies of scale. The severe austerity measures forced upon many members will undermine growth and further exacerbate their unemployment dilemma. Either way, their slow growth will produce less than 1%. Although the breakup of the Euro Land is not in the cards at this stage of the cycle, succession may be another story. **Spain**, which has an unemployment rate of 25%, runs the risk of social disorders. The citizens of Catalonia elected political parties that support independence from the motherland. Many fear this could be the catalyst for secessionist movements through out Euro Land. **Yes, Euro Land remains the wild card in global economic expansion.**

China has overcome their slowdown with a soft landing and is accelerating along the road of economic expansion. However, their housing bubble is still in the process of deflating. With a thriving middle class, the country continues to transform from an export to a consumption-based economy. In the face of social discontent over corruption, their next major domestic project will probabl y be the urbanization of central China. This will bode well for commodities and global expansion. Given Euro Land's contraction, the US has become its number one customer. Either way, China holds the global rebalancing card and will be the star performer in 2013 producing 8% growth at best. On the upside, we may live to see democracy in China.

The **US** fiscal uncertainty will be resolved by the end of February. A positive outcome will support global economic expansion.

Japan, the world's third largest economy, has been in severe recession for decades. With the worst demographics on the planet, consisting of the oldest population, they are and will continue to remain in protracted deflationary stagnation. On the upside, Japan has been able to finance their deficits given the majority of their debts are held by domestic institutions. These investors will remain willing buyers given their lack of faith in their stock market that lost 75% of value since 1989. On the downside, no country has ever survived a debt/GDP ratio exceeding 250% without defaulting. Japan's ratio is currently at 230%. As such, the government is doubling their VAT (sales tax) from 5% to 10% by 2015. They will be lucky to squeeze out 1% GDP. The government needs to expand their quantitative easing, initiate monumental fiscal stimulus to reflate demand and devalue their currency.

In sum, the world is in the midst of a sustainable below trend economic expansion that may take another two to three years to reach pre-recessionary levels of growth. Monetary policy will remain extremely accommodative in an environment that appears more deflationary rather than inflationary. The prerequisite to prosperity lies in global rebalancing, reflation and deleveraging. **Against a backdrop of receding risks and uncertainties, global growth will trend higher producing 4%.** Global growth needs to be bifurcated between the deflationary developed economies producing 2% and the inflationary emerging economies producing 6%. As the expansion picks up steam, the demand for commodities will rise and with it, the economies of Australia, Brazil/Latin America, Russia and Canada. Although remote and on the downside, an implosion in Euro Land and/or a global loss in confidence in the US would be the recipe for disaster. International trade and credit would collapse and all bets would be off the table. **On the upside, absent any geo-political and/or natural disasters, the global expansion should take on momentum in the second half of the year and surpass expectations alleviating the fears of a double dip recession.**

Geo-political Risks

The quest for peace and freedom will continue in the year of living, perhaps more dangerously than in the past. Demographic trends dictate continued political instability, tribal feuding, civil wars, chaos and terrorism in the Islamic world. The Shite and Sunni conflicts are far from containment. **Syria's** civil war has escalated taking 60,000 lives with no end insight. This conflict has spilled over into Turkey and Jordan, Iraq and Lebanon may very well be next. When you consider the presence of the Jihads and emergence of the Kurds in the region, the conflict becomes even more tenuous. Although the peace process in the Promised Land remains in the Dead Sea, the Palestine Authority changed its name to the **State of Palestine** after being granted non-member observer status from the UN. Their belief that they will be granted permanent statehood by the UN is unfounded. The only way for a two state solution is to negotiate with Israel. The **Arab Spring** looks more like the **Arab Winter.** Their historic pursuit of democracy might not be what they fought for. The mere right to vote does not make for a democracy. Egypt elected Islamists to Parliament; Gaza elected terrorists and no one knows what will be in Syria. **Iran's** second largest export is international terrorism. It is allied with Syria, supports Al-Qaeda and finances Hamas in Gaza and Hezbollah in Lebanon. Their nuclear defiance has crushed their economy against the backdrop of surmounting UN sanctions. 2013 represents their year of reckoning given Israel's belief that they will have nuclear capability by midyear. Meanwhile in Asia, **China** and **Japan** remain in dispute over the ownership of a group of uninhabited tiny islands in the East China Sea. The issue is primarily associated with fishing rights but has caused a contraction in trade between the countries estimated at $340 billion. Unpredictable **Venezuela** remains the wild card in Latin America that could shake up the entire region. Chavez, who is allegedly recovering in Cuba, has literally destroyed their economy that is running an inflation rate of 25%, and with it, social unrest. The country continues to be in a state of domestic political repression. The question is not when the inauguration will take place but rather, who will be El Presidente? These world disorders raise both the climate and environment for future crisis, chaos and conflict. The cost of controlling these world disorders depletes our global limited economic resources and impairs our living standards. **There is no prosperity without world peace.**

2013 Economic Forecast

Equities: A year of impressive returns. The 2012 US stock market surpassed my own expectations. The DOW closed the year at 13,104 pulling off a 7.3% rate of return in a year of uncertainty. The S&P 500 closed at 1,426 generating an impressive 13.4% annual return while the NASDAQ closed at 3,020 procreating a superb return of 15.9%. In the prior year, I predicted the Dow, S&P 500 and NASDAQ would close the year at 12,900, 1,350 and 2,850 respectively. While I expected the Dow to reach a high of 13,000 in a trading year of pronounced turmoil, it actually hit 13,610. Notwithstanding the 2012 global contraction, liquidity and corporate earnings primarily fueled the stock markets performance. On a technical perspective, the prerequisite for a bull market run lies in equity valuations, earnings expectations and liquidity. All of these fundamentals remain intact. Although corporate margins continue to be squeezed, historically, equities have done well after they have peaked. Equity valuations are still reasonable even though the S&P is trading at 19 times earnings, well within its historic range. Corporate America has a tendency to surprise on the upside. Given the quantitative easing, investors searching for higher returns in a low-yield world will favor risk assets. Once the dust settles by the end of February after an acceptable resolution of our debt ceiling crisis, we may have reached the turning point in our recovery. Hopefully by midyear, confidence in the economy will be restored. The housing sector will have stabilized and clearly show signs of improvement. The corporate sector will start hiring; investing in capital goods and consumer spending will accelerate along with the stock market. However, the first quarter of the year may very well prove to be quite turbulent with unemployment actually rising rather than falling. **It is more probable than remote that the stock market will be predisposed to a congressional induced correction. The odds favor a 5% plus correction within the first quarter of this year.**

In sum, in this world of low returns, our central banks monetary policies are encouraging investors to take on more risk. Investors are being pushed into reflation trade strategies, ones that favor stocks over bonds. After the correction, stocks will outperform all other asset categories in this sustainable below trend economic expansion. Until the correction, investors should be biased towards capital preservation rather than asset appreciation and should remain in safe havens that encompass high quality bonds and precious metals. These bonds include US treasuries, municipals, US corporates and foreign debt of countries that have their own central banks while the precious metals include gold, silver and platinum. After the correction and in the long-term the emerging markets will outperform their counterparts and to a lesser extent, Wall Street. Investors should consider exchange-traded funds (ETFs) with heavy exposure to China, India and Taiwan and moderate to light exposure to commodity-based countries such as Australia, Brazil, Canada and Mexico. Completely avoid corrupt Russia. With respect to the developed markets, investors who have risk tolerance should consider the attractive valuations of Japan and southern Euro Land whose current performance has a lot further to run. **On the upside, in the US, the Dow and S&P 500 may possibly surpass their 2007 all-time highs of 14,198 and 1,565 respectively.** Cash flow is everything in a deflationary environment. As such, your primary objective should be investing in high-yield dividend equities in companies with a consistent track record. With respect to US sectors, consider diversified overweight positions in technology, energy, healthcare, real estate and select industrials and underweight in both defense and consumer staples with the exception of retailers who sell exclusively online.

Notwithstanding the run-up in financials, they should surprise on the upside since they started from depressed valuation levels. The investment banks, flush with cash will benefit from renewed merger and acquisition activity and new issues. On the downside, our insolvent government's failure to implement appropriate austerity measures may trigger a domestic and global loss of confidence in our economy.

> **Absent any geo-political and/or natural disasters, the forecast assumes appropriate resolution of our debt ceiling crisis and improved economic fundamentals in Euro Land. Against this backdrop, the Dow may trade between ranges of 12,500 and 15,000 closing the year at 14,500. The S&P 500 and NASDAQ may close the year at 1,650 and 3,600 respectively. The trading year may be one of elevated turbulence primarily within the first quarter where the market will rise on good news and fall on bad. The market will be vulnerable to a congressionally induced correction of 5% plus. After the uncertainties with respect to our debt ceiling crisis recedes, the market should accelerate in a less volatile environment consisting of renewed confidence and optimism.**

Interest Rates: It remains difficult to support the case that interest rates will continue to fall given their current historic lows. In this deflationary environment, the Fed's aggressive monetary policy will remain intact. The Fed has clearly stated they will continue their quantitative easing program by purchasing Treasuries and mortgage-backed securities at the rate of $85 billion a month with the intent of lowering the long-term interest rates to the benefit of the housing sector. Lower rates may be achievable in the first half of the year but as the economy picks up momentum rates are more likely to rise rather than fall. The 30-year and 10-year treasury yields closed the year at 1.75% and 2.9% respectively. Both rates may rise by 50 basis points at best yielding 2.25% and 3.4% respectively. **As such, it may be the time to refinance your mortgages before the 30-year mortgage rates rise from 3.34% to possibly 3.75%.** On the investment interest side, investors should consider investment-grade high-yield corporate bonds and sovereign debt in countries that have their own central banks and strong currency fundamentals. US treasuries appear less compelling with the exception as a safe haven investment.

Municipal Bonds: Although the yields on high-quality bonds are lower than a year ago, their fundamentals clearly remain solid. State governments are required to balance their budgets on an annual basis. They have made great progress in deleveraging and their layoffs have subsided. The risks of loss continue to be benign without any AAA rated bond defaults. The increase in federal income taxes on investment income for the wealthy will bode well for the demand of these bonds that are in limited supply. On the downside, when the Fed reverses their aggressive monetary policy to restraint, the Muni-bond market will get crushed. The early warning signs of this Fed action consists of the economy approaching normal trend GDP of 3.5% and unemployment falling towards 6.5%. It is more probable that this may occur in 2014 rather than this year, but either way investors need to be alert and aware.

The US Dollar: The long-term bear market remains well entrenched. No country wants a strong currency during a recovery. The belief that we may become subject to currency wars and/or competitive devaluations is misplaced. The Fed's quantitative easing has contributed to the devaluation of the dollar to the dissatisfaction of the world. However, this depreciation should remain relatively benign. The dollar may firm up in the short-term given that other global currencies lack the economic fundamentals to replace it. Besides, the dollar is considered a safe haven. Thereafter, the dollar may drop by 5% or more against the backdrop of improving global economic conditions and the continuation of our quantitative easing. The dollar will rise against the yen and fall against the euro. On the upside, both the Chinese renmimbi and Indian rupee are likely to appreciate against the dollar. **The US dollar will remain the global currency of choice and the bear market has many years to run.**

Gross Domestic Product (GDP): When all is tallied, our domestic 2012 anemic growth will be approximately 2%. This is far below the 3% prerequisite growth required to produce meaningful job creation. It may take two to three years of above trend growth before the unemployment rate falls to 6.5%. This is the rate that I contend represents our economy at full employment rather than the historic 5.4% upheld by our leading economists. Our modern day economy is constantly evolving as a result of technological innovation and with it; many in our work force will become unemployable. Against the backdrop of improving domestic and global economic fundamenta ls, our growth should accelerate in the second half of the year generating GDP of 3.5% and closing the year at 2.75%. Global growth will trend higher producing 4% with the emerging economies contributing 6% and the developed economies contributing 2%.

Inflation / Deflation: The emerging world is inflationary while the developed world is deflationary. Deflation is the most destructive underlying force in any economy. The Fed's battle against deflation is the creation of their inflationary injection known as quantitative easing. Given our aggressive monetary policy and excess capacity in our economy, core inflation fell to 1.8%. In 2013, core inflation will be relatively benign rising within an acceptable range of 2 to 2.5% as excess capacity gets absorbed in our economic expansion. So there is no misunderstanding, the high inflationary stage of the 80-year economic cycle of life follows the deflationary stage. However, this may be two to three years down the road.

Gold / Silver: Global aggressive monetary policies combined with currency debasements will continue to support the value of gold and silver in the short-term. Gold closed the year at $1675 per ounce producing a below trend rate of return of 7%. Gold is a currency that cannot be debased and rises during periods of war, global uncertainty, financial crisis and growing inflationary expectations. Gold may possibly hit $2,000 per ounce during the debt ceiling crisis and recede after these issues are resolved, closing the year at $1,800 per ounce. **Now is the time to invest in both gold and silver**. On the other hand, **Hi-Ho Silver** will outperform gold. Silver closed the year at $30 per ounce also producing a below trend rate of return of 7%. However, its fundamentals differ from gold given its global industrial demand that will rise during the economic expansion. It is possible silver could hit $40 per ounce then recede after the debt ceiling crisis is resolved, closing the year at $35 per ounce. On a long-term perspective, both gold and silver will shine in an inflationary environment.

Other Commodities: The commodities bear market remains intact in the short-term. By midyear, hard and soft commodity prices should move higher along with global economic expansion primarily from China. Many commodities are facing supply constraints that will support rising prices as demand accelerates. This will bode well for the commodity-based economies of the world.

Oil & Gas: The demand for oil has retrenched along with the contracting global economy. The price per barrel has been quite resilient in this environment and has remained in its two year trading range of $80-$115. Demand will rise as the global economy picks up momentum. On the other hand, the supply will also rise given the continued expansion in US production. This years trading range should not be much different. Notwithstanding the fact we are the world's largest importer, our crude oil products represents the largest dollar value of our exports. **The US is on the road to energy independence hopefully to be achieved by 2020.** This would have profound political ramifications in the world. The wildcard associated with the turmoil in oil rests with Iran. A negotiated settlement this year will remove the risk premium incorporated in the current price per barrel. Otherwise, the price of oil will rise. **The gas bear market remains intact.** The underlying fundamentals remain smelly. Even with rising demand and falling supplies, the price per million BTU will probably not exceed $3.75, far less than the $4 threshold for profitability. **Since crude oil is traded in US dollars, the long-term perspective for this commodity is bullish.**

Real Estate: New construction of single-family homes, condominiums and apartments continue to surprise on the upside. This improvement still is not enough to keep up with the population including new-home buyers. The new construction expansion will be fueled by mortgages with rates at historic lows. The resale market appears to have bottomed showing signs of improved valuations. However, this may very well be misleading. A large portion of the sales activities is associated with investors, speculators and foreigners. Approximately 25% of mortgages are still under water. Ninety percent of the foreclosed properties remain in the hands of the banks. The banks will liquidate them slowly in order to maintain and improve valuations. This enormous inventory of vacant properties will continue to be a drag on the housing recovery. As such, the residential real estate downturn will continue to persist in the long run. On the upside, it should not jeopardize the economic recovery. Congress was unsuccessful in allowing both Fannie Mae and Freddie Mac to refinance properties no matter how much they were under water. The reduced mortgage payment would have enhanced disposable income that would have benefited the economy. **As we are all aware, our government is clearly dysfunctional.**

2013 may turn out to be our lucky year and the turning point of our recovery.
I remain optimistic about the Outlook.