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Economic Outlook 2013
A Long-Range Economic Look at the year 2013
Economic Outlook

**Economy**

**POSITIVES**
- Manufacturing new orders are rising
- Improving home sales/prices
- Uptick in auto sales

**NEGATIVES**
- Higher taxes
- Too many regulations
- Quantitative Easing ineffective
- Stronger dollar and supplier exports

Unfortunately, the economy faces many hurdles. Politicians often try economic "fixes" that lead to hardships in post-election years as the prospect of voter wrath is far away. Since 1945 post-election years have been touched by a recession 56% of the time.

Higher taxes in 2013 will curtail disposable spending. Our analysis of individual state tax codes over the last ten years suggests higher tax rates hurts economic growth and job gains. Surprisingly, it also leads to slower tax revenue growth than states with lower tax rates.

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**Stocks**

**POSITIVES**
- The FED is flooding the markets with money (Quantitative Easing!)
- Cheaper energy revivifies consumption, encourages industrial production
- The fleet of automobiles on the road are aged, many need to be replaced
- The housing slump is ending
- Low borrowing costs benefit financial institutions
- Abundant liquidity is available for stock purchases

**NEGATIVES**
- Stock prices are not at bargain levels
- Corporate earnings outstrip corporate revenues
- Taxes are going higher
- Post-election years are historically difficult
- Economic growth has been slow
- Government defense spending may be curtailed

Traditionally, the year after a presidential election is the most difficult for stock investors. Government spending is often curtailed. All around the developed world, be it China, Japan or Europe, exports mark face problems. Excessive debt has depressed spending power by our traditional trading partners, and debt threatens our country. For these reasons, we look for a difficult year.

In spite of volatile markets and uncertain days ahead, opportunities exist for good investment returns. As 2012 ends, excessive pessimism makes stocks temporarily more attractive than bonds. Lower energy prices attract business ventures from here and abroad, while consumers yearn to replace aged automobiles and meters into better homes. Profits for financial companies shift higher as their interest costs are low.

**Bonds**

**POSITIVES**
- Economic worries are beneficial for bonds
- International unrest encourages flight to safety
- Contrarian opinions present opportunities
- Municipal bonds offer tax advantages

**NEGATIVES**
- Quantitative Easing policies push rates higher
- Too much government spending may erode confidence
- Bonds lag when housing recovers
- Debt crisis still looms
- Inflationary pressures are mounting
- Tax increases accompanied by mandatory spending cuts at the start of 2013 have brought about the concern over a Fiscal Cliff. Tax revenues have been rising slightly but extraordinarily high spending is the problem.

Federal income taxes are going higher. Depending on their structure, municipal bonds may offer relief for taxable accounts.

The Federal Reserve put Quantitative Easing in place with the intention of pushing rates lower. However, this process increases the money supply and had the unintentional consequence of causing investors to fear inflation. Instead of pushing rates lower, bond yields actually rose during the first two periods of Quantitative Easing. (However, after they ended) bond yields fell, which gave bond investors a boost.

During much of 2012, lower quality bonds have led the way. In fact High-Yield bonds provided the best total return. With so many uncertainties in the world, unemployment, slow economic growth, Europe and rising tensions in the Middle East; a further flight to quality may occur. While lower quality bonds will reflect movements in stocks, we suggest investors start to shift to lower risk, higher quality issuers.

**International**

**POSITIVES**
- Growth remains robust in Poland and Turkey
- Indonesian economy is starting to rebound
- Growth is replacing austerity as an objective in Europe
- East Asian countries have room to maneuver
- African economies are showing signs of sustained growth

**NEGATIVES**
- Europe falling deeper into recession
- Commodity rally coming to an end
- Change of power in Japan creates uncertainty
- Investment in Euro-zone has come to a halt
- Fears of the Middle-Income Trap haunt China

Europe continues to resist the changes it needs to deal with its debt crisis, preferring talk over cure. The lack of investment in Europe casts doubt on its ability to grow. Russia is totally dependent on oil exports and doomed to follow the large economies of Europe. France’s socialist agenda will drive business abroad.

While Europe and the US may be averted in political limbo, the rest of the world will try to get along without them. The large and diverse economies of Brazil and Indonesia can shrug off the end of the commodity rally and focus on internal growth. Commodity importing nations, such as Malaysia and Turkey will benefit from stable but falling commodity prices.

Singapore will gain from the rising regulatory burdens in the West, the Philippines will benefit from peace within in its borders and South Korea will continue to respond quickly and efficiently to new sources of demand for its many products. While sensitive to exports, some African nations are growing fast and are low cost producers, so even deepening recession in Europe may not hold them back.

**Conclusions for 2013**

- Business confidence is lacking
- Federal spending growth will moderate
- Export opportunities are questionable
- Prepare now for future inflation
- Take advantage of low interest rates
- Adjust expectations for higher taxes
- Don’t overstaff
- Energy costs will fall

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**For Business Executives**
- Lower energy costs help manufacturers
- Look for modest post-election year returns
- New regulations favor international investing
- Increased volatility likely
- Favor high quality bonds
- Expect recovery in housing and auto sectors
- Financial companies can take advantage of low costs

**For Investors**
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**Earnings Outlook**

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