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Review & Outlook: Third Quarter 2012

Review

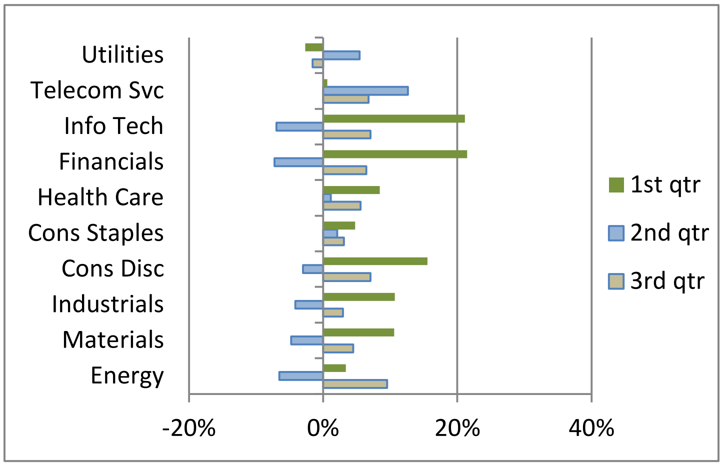
The major stock indexes in the U.S. increased nicely during the third quarter. A major reason for the increase was the Federal Reserve's decision to inject money into the economy by purchasing mortgage-backed securities until conditions improved in the labor market. Targeting employment and having an asset-purchase program with no expiration date are new steps for the Fed. In addition, positive announcements by the European Central Bank, key legal decisions in Germany, and actions in Spain also helped boost investor confidence and pushed the market higher.

In the end, the S&P 500 Index returned 6.35% for the quarter. The S&P 500 is now up 16.44% year-to-date. These figures are for total returns, which include dividends. Additionally, please note that the S&P returns are 'capitalization weighted'. The performance of large companies in the index has a disproportionate impact on returns. Apple's gain of 65% year-to-date accounts for almost 25% (4 out of 16.4 percentage points) of the S&P 500's return this year. Because of its capitalization, Apple accounted for 75% of the year-to-date return for the Information Technology sector, one of the strongest sectors in 2012. It is important to remember the potential impact of a single security on headline performance data. Particularly when that single security could be vulnerable.

S&P 500 Performance by Economic Sector

Figure 1 shows the performance by economic sector of the S&P 500 during the 1st, 2nd, and 3rd quarters of 2012.

Figure 1: S&P 500 Index Performance by Sector



Source: Standard and Poor's Financial Services LLC Web Site

The quarter-to-quarter volatility between sectors seems to be the norm for now. Volatility between groups *within* sectors has also increased dramatically.

Outlook

The near-term outlook will depend on the resolution of 'fiscal cliff' issues; the effectiveness of the Fed's actions; and the effectiveness of European leaders in managing the debt problems in Greece, Spain, and Italy.

We anticipate that many of the difficult decisions related to the 'fiscal cliff' will be pushed ahead into 2013. The continued uncertainty will not help the labor market, but may give stocks a little breathing room. Stocks would almost certainly fall sharply if Congress fails to come to some compromise on the automatic spending cuts and tax increases that comprise the “fiscal cliff”. Still, we have moved to a slightly more defensive position to protect against government inaction and related uncertainty.

Most published forecasts do not predict the Fed’s actions as having a significant impact on GDP growth. In addition, it seems most of the potential impact on the stock market has already happened.

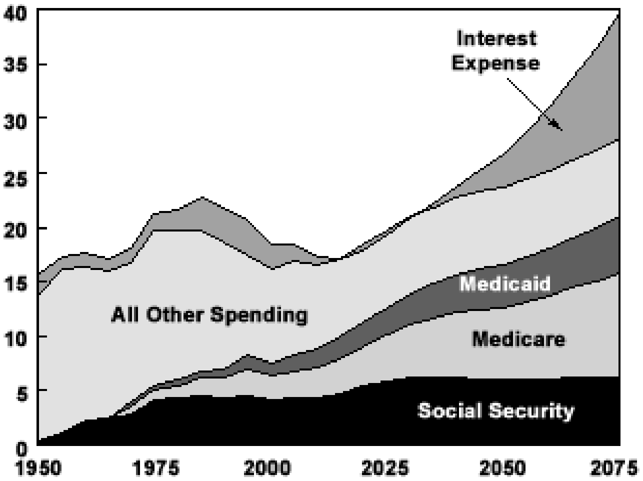
China presents another quandary for investors. China is simultaneously experiencing slower economic growth and significant wage growth. Short term, the export based economy in China is likely to struggle as Europe and others cut imports. The slowdown will impact China’s imports from the US. Longer term, wage growth in China and technology changes could help the manufacturing sector at home.

The slow-down in China and Europe will likely impact corporate earnings. Corporate earnings for the third quarter may be lower than the same quarter one year ago, and stock prices may fall slightly as a result. We’re exploring how best to reduce our holdings in certain sectors in anticipation of lower earnings, and how to handle the weakness in global activity.

In general, we expect GDP growth in the U.S. under 2% this year and only slightly above 2% in 2013. Moreover, we do not see strong growth occurring until we deal with fundamental issues like the debt – which we consider to be largely a matter of health care financing.

The following graphic shows the components of GDP. The figure was prepared by the Congressional Budget Office to highlight the role of health care expenditures in the growing U.S. debt.

Figure 2: Money Supply (Measured by M2) Over Time



Finally, we would be remiss if we did not mention the risk of inflation given recent Federal Reserve policy decisions. Many economists believe that increasing the money supply so much while the economy is growing so little will cause inflation. However, others believe the relationship between various measures of money supply and variables such as GDP growth and inflation have changed over time or broken down. They do not see inevitable inflation with changes in the money supply, or they believe that the benefits outweigh the risk of inflation.

Without trying to settle that argument, we know that inflation, the expectation of inflation, or higher interest rates for whatever reason will drive bond prices down. We believe investors should start reducing the maturity of their bond portfolios, and give preference to individual bonds over bond mutual funds. Both actions will reduce the impact of rising interest rates.

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