OUTLOOK FOR 2013

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As I predicted, we got through the last fiscal cliff in fine stead. The Republicans have just announced that they will vote for a three-month delay in the debt limit. Some believe that in June we will face an even more serious threat to the market if the GOP refuses to increase the borrowing limit. But I disagree. The Republicans tried to shut down the government when the Clinton administration hit the debt ceiling, and it led to a sharp drop in GOP ratings. Republicans are in no stronger a position today. An outright increase in the debt ceiling will be reached. Some worry that if no significant expenditure cuts are made, there is a risk that Standard and Poor's or another ratings agency will further downgrade U.S. government debt. While that may indeed occur, I do not think it will have a significant impact on the market. Stockholders may remember that when S&P downgraded the federal government debt in August 2011, the stock market took a tumble. But that was because there was a fear that China might dump a significant portion of its U.S. Treasury portfolio, an event that never came to pass—and stocks recovered. And the S&P downgrade had absolutely no impact on the Treasury market itself; in fact, demand for Treasury bonds actually boomed following the downgrade, as investors sought U.S. bonds as a "safe haven" investment. What does all this mean for the economy and the markets? I think that stocks will continue to surprise on the upside, and I believe stocks will return at least the 16% they achieved last year. Most of this gain will be generated from an expansion of P/E multiples [will link to the P/E ratio definition in the glossary], as I expect earnings to be up from 5% to 7% over 2012. Multiple expansion is in the cards when interest rates are this low. I believe S&P 500 [will link to the S&P 500 Index definition in the glossary] earnings will be in the $105 to $110 range for 2013, which at the current level of 1470 for the index puts the P/E ratio at about 13.7, far lower than the average over the past 50 years. The tax battle is over, and it did not turn out too badly for investors. I have long maintained that Obama's proposal to eliminate the special rate on dividends was a bargaining chip that would be discarded quickly when the final deal was done. The outcome is that the highest rate for dividends is at 23.8% (including the Medicare tax), the exact same as capital gains, and this rate kicks in at a joint income of over $450,000 instead of over $250,000. This means that the highest tax rate impacts less than one-quarter of the dividends that are paid and that most middle- to upper-middle-income investors will be paying a 15% tax (or lower) on their dividend income. With ordinary tax rates rising sharply for high-income individuals, dividend income is still extremely attractive. On the interest rate front I believe the Fed will tighten sooner than the middle of 2015, the date the Federal Open Market Committee predicts it will start raising rates. This is because the recent job growth numbers of 150,000 per month should bring the unemployment rate down to the newly revealed threshold of 6.5% some time in 2014, not 2015. But stock owners need not fear an earlier tightening. Bull markets die only in the final stages of central bank tightening, when interest rates reach much higher levels. I believe this bull has a long way to run.

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