John Dessauer Investments, Inc.

John Dessauer's Outlook

January 2013

After the Cliff, Modest Expectations For the New Year

Senator Rand Paul, in a CNN interview on December 31, was right. He said the deal reached between Senate Minority Leader McConnell and Vice President Biden to resolve the fiscal cliff would have bipartisan support in the Senate and the House. He also said he would vote against it, because the deal did not address the core problems of debt and deficits. Senator Paul was wrong to vote no. This deal is to make sure the economy does not suffer another nasty recession. Deficits and debts get worse during recessions. Preventing a recession is a necessary first step in addressing the unsustainable deficits and growing national debt. Furthermore, the bipartisan support makes this a truly big deal. It says both parties can find common ground on important fiscal policy issues.

There still is work to do on the spending side, and shortly the national debt ceiling will be reached. More political battling is to be expected. At least now we do not have the monster tax hike and draconian spending cuts hanging over the economy. The housing recovery will continue. Consumers and business managers will be able to relax and have confidence that the economy will keep growing, albeit more slowly than we would like.

As December 31 drew near, the stakes involved with the fiscal cliff became clearer. Over the cliff would have meant the largest tax hike for Americans since World War Two. Worst hit would be low income Americans. That is the case, because the Bush tax cuts favored lower incomes far more than any other group, even the middle class. On the spending side, the Secretary of Defense said slashing spending under the

sequestration could mean the loss of 800,000 jobs. Pencil pushers in Washington said the tax hikes and spending cuts would reduce the deficit. They live in a static, never changing, fuzzy kind of world. The real, dynamic world works in a far different manner. The recession of 2008 dramatically increased the federal deficit because tax collections went down and spending went up. The same would happen in a recession caused by draconian spending cuts and huge increase in tax rates. Recessions, no matter the cause, do not reduce government deficits. They do exactly the opposite. Thank goodness there was a deal so the economy can keep growing.

American investors' tragic mistake

Haunted by the financial crisis of 2008, American investors made a $200 billion mistake. According to data compiled by Bloomberg and Morningstar, that is the amount they left on the table by selling stocks, instead of hanging on for the recovery which has come close to doubling stock prices since the March 2009 low. Not that it has been easy for those of us who did hang on. Over the past four years we have endured record daily price swings and three market plunges of at least 9.9%, including the very scary "flash crash" on May 6, 2010. While the extreme volatility has stopped, the average daily stock market move in 2012 has been 0.59%, a far cry from the 1.74% in 2008. We still face an array of serious concerns about economic conditions at home and in Europe. Many investors find the combination of a slow-growth economy, high unemployment and uncertainty about the future for jobs, the record annual federal government deficits and our huge and growing national debt too much to bear. They see the stock market rally since March 2009 as an invitation to sell. The outflow from stocks and equity mutual funds goes on. In 2012 individual American investors sold another $152 billion worth of stocks. Twelve months from now, the level of regret may not be as high, but those who are selling are likely to wish they had hung on for at least one more year.

Lessons from the past four years

Trading in the post-2008 environment has been tough

You might think that a volatile market would be a boon to traders. Lots of activity and stock price motion would seem to offer a better chance for catching profits from the swings in price. That has not been the case these last four years. The activity has often been random - based on sudden,

unpredictable shifts in sentiment. Sometimes it was news from Europe that caused the volatility. The next time it would be news from China, or developments here at home. The market reacted in mysterious ways to the various bits of news. The background, with massive selling by individuals and selective buying by institutional investors, is most likely what made it so difficult for traders to profit. The "flash crash" in May of 2010 caught most traders off guard. They suffered significant losses and struggled to recover.

Trading remained difficult even as the volatility declined. Hedge funds, notorious for taking successful contrary positions and trading for great profits, were one of the worst performers in 2012.

Buy and hold worked

After the market plunged in late 2008 and early 2009, the financial media and scores of market pundits declared the buy and hold stock strategy totally dead. For sure, everyone who held on to bank stocks agreed, at least for the moment. By March 2009, we all wished we had sold at least some of our bank stocks. A lucky few did, but most had enjoyed huge profits holding on to bank stocks over the years. It was hard to believe that so many banks were so thoroughly devastated by the financial crisis and real estate collapse. It was a mistake to hold on to bank stocks through the financial crisis. However, many made a second mistake that crushed their net worth. They assumed that what had happened to bank stocks was going to happen to all stocks. They were wrong. Most stocks recovered. Holding on and benefiting from the recovery was the right strategy. Now that the market has largely recovered, buy and hold is once again being questioned. Will the stock market plunge again as our self-inflicted fiscal economic wounds take hold? While possible, that seems unlikely.

U.S. stocks are cheap. The gap between the yield on ten-year Treasury bonds and the earnings yield on stocks is at an unprecedented high. The current earnings yield on the S&P 500 Index is 7.2%. The yield on ten-year Treasury bonds is 1.83%, for a gap of 5.37%. The Federal Reserve's model says stocks and bonds are at equilibrium when the earnings yield and the ten-year Treasury bond yield are the same. We are clearly a long way from equilibrium, and ten-year Treasury bond yields are not likely to rise very much, if at all in the coming year. History shows that it is extremely rare for the earnings yield gap to be 6%. More often the earnings yield gap is well

below 6%. As a practical matter, the only way the yield gap can be closed in the near term is for stock prices to rise.

Stocks and the economy can go in different directions

The U.S. media would have us believe that stocks always follow the economy. When there was news about a coming recession in Europe, U.S. stocks went down. Likewise, they went down when there was news that China's economy was slowing. U.S. stocks have also headed lower whenever there has been news that our politicians were having difficulty solving the fiscal cliff issues. Fear of the consequences of our fiscal mess is the main reason that so many have been selling so many stocks since the financial crisis of 2008. The U.S. economy did suffer a nasty recession, and has been in a disappointing slow recovery mode since. Contrary to what many expected, the U.S. stock market has done far better than the broad economy.

A full blown economic collapse can drive stocks lower. The Greek stock index collapsed after the 2008 financial crisis, falling from 5,132 to 476, before rallying. However, this might come as a surprise: Greek stocks were up 90% last year, rising to 913. And, according to *The Economist* magazine, Greek government bonds also turned the corner to become one of the top performing asset classes in 2012 - up more than 80%.

As the euro region slipped into recession last year, European stocks went in the opposite direction. German stocks rose 30%. French stocks were up 16%. The euro area stock index (DJ STOXX 50) rose more than 14%.

The global economy is the explanation for the better than expected performance of so many stock markets. Stock market indices tend to consist of stocks in larger companies that are participating in the global economy. The pessimists have a point. There is a price to be paid for creating a fiscal mess and depressing economic growth. That price is paid by entrepreneurs and small businesses. They find it difficult to create new businesses and to expand existing ones. The end result is lackluster job creation and slow growth in wages. However, larger, well-established businesses actually benefit from the lack of inflation, plentiful job applications and opportunities around the world.

Do not follow the crowd

Obviously the crowd has been wrong to keep selling stocks. However, that is not the only example where following the crowd produced disappointing results. What were the most popular assets a year ago? The answer is: gold, commodities and utility stocks. Gold is down about $100 an ounce. Commodities and utility stocks are flat. Commodities have suffered from the fundamentals - slower growth in the global economy. Gold's rise ran out of steam as all who wanted to buy did so, leaving few to provide support from any profit taking. Utility stocks were just pushed up too soon. Like commodities, they too suffered from the slow economy and high unemployment.

What is most popular right now? The crowd today is hungry for liquidity and safety. Holding cash will not produce a nominal loss, but also will not provide any income or capital gain. When it comes to safety, the crowd still likes Treasury bills. Like cash, they don't provide much income, but because they are short term investments, they won't produce a loss either. A year ago stocks were a good choice. Given that they are definitely not high priced, and that the crowd is still selling, stocks once again look good for the coming twelve months.

Expectations for the global economy

Europe

This will be a much better year for Europe, thanks to the bond buying program by the European Central Bank.

Europe is in recession. The latest data on euro region members shows that economic block contracting at a 0.6% rate. Germany, France, and Austria are still growing, but their contribution is more than offset by contraction in the other euro region economies. The root cause of the recession is the sovereign debt crisis and the forced austerity that has followed. Governments - including Greece, Portugal, Ireland, Italy and Spain - have been forced to cut spending because of rising interest rates. Bond buyers in the open market have demanded higher interest rates. Strapped governments have no choice - they must pay the interest costs or face default and all of its ugly consequences. In response, discretionary spending on a wide range of government programs has been cut. Until the euro central bank changed course and began buying government bonds,

there was fear the euro would spin apart as austerity drove up unemployment. The bond buying program does not solve all the euro's problems. The sovereign debt crisis has not gone away. However, the bond buying is a major step in the direction of solving the euro's fiscal responsibility issue. Bond buying by the euro central bank is already having a positive effect. The European sovereign debt crisis is now less severe.

The central bank's bond-buying program, in effect, establishes a central authority over all the euro region banks. This is a significant step in reining in politicians' ability to keep borrowing and spending. Greece, Spain, Portugal, Italy and even France have been punished by the bond market. They are now fully aware that there is a limit to how much they can borrow in the open market. Greece hit the limit, with devastating economic consequences. Spain and Portugal came close to following Greece. Italy changed government policies just in time to avoid a devastating spike in interest rates.

A government - like Greece - that is spending far more than it is collecting in revenue is vulnerable. When the government can't borrow any more, a punishing form of austerity in the form of a deep spending cut is imposed. The grim result can be seen on the streets in Athens and in the extremely high and rising unemployment rate (26% in Greece).

The classic response to fiscal irresponsibility has been to print money and devalue the currency. Euro region governments are denied that option because the ability to print money rests with the European Central Bank and not the governments of the various members. Because of the destructive inflation of the 1970s and the history of currency devaluation in Europe, the European Central Bank from the first day of its creation established inflation as enemy number one. When the sovereign debt crisis blossomed, battle began. Distressed governments begged for help in the form of printing more money. Germany led the opposition to that idea. Before the creation of the euro, Germany had fought hard to keep inflation down and bragged about its success. Germany argued that staying tough on inflation was the right way to solve the crisis and restart economic growth. Time has shown there are faults with the German approach. The suffering required by the weaker euro members is a threat to the entire union. Germany has since softened its resistance to printing money. Mario Draghi has cautiously taken advantage of the new situation and developed a government bond buying program.

When a central bank buys government bonds, it is adding money to the system. The central bank does not actually print more money. Instead it increases, through electronic deposits, the amount of cash available for banks to use. Distressed euro region governments now have a second option when it comes to financing their debts. There always is a psychological element to economics. The euro bond buying has raised confidence that the euro will survive. Greek government bonds rose more than 80% last year. Portuguese government bonds were up almost 80%.

The bond buying does more than simply add cash to the various banking systems. For the first time, it gives the euro central bank authority over the banks. To qualify for the buying, banks must meet specific financial criteria. In addition, the central bank sends a message to the distressed governments: namely, that while there will be bond buying, it will continue only as long as there is real progress on deficit reduction.

To be sure, there is much more work to be done before the euro's future is secure. However, this first step is significant and it will mean the recession in Europe will be much milder than it otherwise would have been.

China

Pessimists said China was heading for a hard landing. Inflation was thought to be rising and beyond the central bank's control. They were right on some points, most notably wages. Chinese wages have been rising. They are up so much that China is no longer a low cost labor destination for businesses. But, on the hard landing they have been very wrong. Inflation in China is falling, now at about 2%, down from nearly 3% twelve months ago. Economic growth is running at an annual rate of 7.4% and gaining strength. China will be an important engine of growth for the global economy this year.

The top forecaster for China, among the hundreds of economists in a Bloomberg Markets survey, is Song Yu, from Goldman Sachs. Song became interested in economics as a child growing up in Northeastern China, watching Deng Xiaoping's leadership bring prosperity where there had been abject poverty.

Song says: "Every single year, there was change in your living standard, and every ten years, you just see a dramatic change in terms of the

life around you and also in the whole economy." During my many visits to China - including rural China in the 1990s and early 2000s - I saw the same energy and enthusiasm. Pessimists who predict hard landings for China at the end of every cycle come up wrong because they have not gone out into the countryside and seen the Chinese people at work. Song Yu says China needs more government-led socioeconomic change to spur growth. I agree, and also believe China will change, and that domestic growth will keep increasing year after year. Song Yu says he continues to be excited by the rapid evolution of China's society and economy. We should pay more attention to Song Yu's analysis and forecasts than to the China bashers. China is likely to grow at a rate well above the global average for a long time.

The United States

One very explosive can has been kicked down the road, but only for a month. The longshoreman's union threatens a strike that would have closed container ports all along the east and gulf coasts. Just 48 hours before the strike deadline, the union agreed to extend the contract until early February. While the strike would involve less than 15,000 longshoremen, it would have devastating consequences for the entire economy. Many more thousands would lose their jobs. The extension came after a major issue - royalties on containers - was resolved. Odds are that the remaining lesser issues will be worked out before this month is over. The idea of a longshoreman's strike *and* the fiscal cliff was very scary. That combination would have crushed the economy, sending us back into a nasty recession. No wonder the stock market was down sharply on Friday the 28th.

The union agreement left the economy still exposed to the other explosive can: the so-called fiscal cliff. The President flew back from Hawaii. The House and Senate came back to work, and all parties finally got serious about working out a compromise that all could accept. Republicans talked about minimizing the damage from the fiscal cliff. Democrats talked about raising the threshold for higher tax rates, perhaps to $400,000 instead of $250,000.

Whether Americans realize it or not, the fiscal cliff involves a whole lot more than raising tax rates on the rich. An old agriculture bill expired on 12/31/2012. Unless extended, it would mean a steep rise in the cost of milk, perhaps $2.00 a gallon. A debt forgiveness change signed by President Bush

in 2007 also was set to expire. Under the old rule, if a bank did not pursue the balance due on a mortgage after a foreclosure, the homeowner was subject to income taxes on the amount “forgiven.” The marriage penalty correction ran out at year end. Child tax credits were set to rise. The IRS did not know what to do amid the uncertainty. Lines on the 1040 that used to allow deductions for teachers’ supplies, medical expenses, and others were marked “reserved.” And of course there is the AMT (Alternative Minimum Tax), which needs a patch every year or else 28-30 million Americans would find themselves branded as “rich” and be forced to pay thousands of dollars in additional income taxes. The fiscal cliff would be a terrible way to educate Americans about the AMT, which was a “Tax the Rich” idea that has long since gone bad. But clearly Americans need an education on just how convoluted our tax code has become. If it bit them personally, perhaps they might support badly needed tax reform.

The Rest of the World

There are pockets of growth in surprising places. Among emerging markets, Indonesia is growing at a 6.2% rate, Malaysia at a 5.2% rate, and India at a 5.3% rate. Closer to home, Mexico is growing at a 3.3% rate. In South America, Chile is growing at a 5.7% rate and Columbia at a 4.9% rate. There is even hope for Japan. Its economy is barely growing, but the new government is making some bold proposals that finally might get that economy on the road to growth.

Conclusion

Coming out of the deep recession, the growth rate for the global economy accelerated to 5% in 2010. Burdened by Europe’s sovereign debt crisis and a slow U.S. recovery, global growth slowed to 3.75% in 2011. While all the numbers have not yet been counted, the evidence says global growth slowed again in 2012, down to 3%. Richard Hoey, chief economist for BNY Mellon, thinks global growth will improve slightly this year, rising to 3.3%. He thinks the year will start out slowly and that growth will strengthen in the second half. For investors, growth of 4%-5% would be much better than 3%-3.3%, but until economic conditions improve in Europe and the United States, we will have to be satisfied with slow growth.

Investment strategy

The experts at BNY Mellon say that equities will do well again this year. For the S&P 500 stock index, they expect earnings in 2013 to grow by 5%-10%. If the economy improves during the year, odds are the P/E will rise. However, erring on the side of caution, the BNY Mellon experts assume no P/E expansion. That means stock prices will follow earnings for a capital gain of 5%-10%. Add in dividends, and the total return becomes 7%-12%. Personally, I expect some rise in the P/E as earnings continue to beat expectations and the economy improves. In support of my more optimistic expectation, there is a very good chance that sometime this year we will see a boost in capital spending by businesses. The reason is that they have to play catch-up because they have been holding back, waiting for more certainty on the outlook for final demand, and for the burst in new technologies to calm down. They are now running out of time. Now the greater risk is falling behind the competition.

For a different reason, Lazlo Birinyi, my former Wall Street Week colleague, thinks the S&P 500 will hit a new record high this year. He thinks individual investors will come back to equities, providing the buying power to push stocks to new highs. The point is that there are good reasons to believe in stocks for 2013. Stocks in larger, financially strong companies remain the best choice.

COMPANY NEWS AND VIEWS

General Electric, NYSE, GE, $20.73 has made significant progress restructuring its businesses and adapting to the new slower growth global environment. In the third quarter, all of GE's industrial business segments showed positive earnings growth for the first time since 2005. GE Capital is recovering, and was able to pay a second dividend to the parent company in the third quarter. For this year, earnings are on track for $1.55 a share. Next year earnings should grow by 13% to $1.75 a share. In light of the improving fundamentals, GE has raised the quarterly dividend by 12% to $0.19 a share. That raises the annual yield to 3.7%. I expect to see another dividend increase next year. GE is a solid investment choice with above average total return potential. My twelve month price target is $26. My advice is to buy GE below $22.

Intel, NASDAQ, $20.44. I am not alone with my buy recommendation and optimistic outlook for Intel. David Wong, analyst at

Wells Fargo, has reiterated his Outperform rating on Intel's stock. His valuation range is $28-$33 and he calls Intel his "Top Pick." He has raised his earnings estimate for 2012 to $2.10 saying the company's market for server chips "offers excellent growth potential." The stock at about ten times 2012 earnings is deeply undervalued. Intel is a buy.

Nokia, NYSE, NOK, $3.92. There have been two more positive developments for Nokia. First, Nokia has made a deal with state-owned China Mobile to distribute Nokia smartphones. Nokia has a long term relationship with China, and has been supplying inexpensive phones for that market for years. Analysts used to criticize Nokia because the profit margins on its China business were much thinner than in other markets. True enough, but now with new smartphones and the Windows 8 platform, margins in China are likely to improve. The second positive development is that Nokia's new smartphones are much faster than Apple's in the European 4G LTE market. LTE stands for Long Term Evolution. These two positives explain the changes in recommendations among Scandinavian analysts. They have gone from sell to hold and in some cases buy. American analysts remain on the sell side. I think the Scandinavians are probably better tuned to Nokia and its markets. However, I am not ready to say buy. My rating remains hold.

Pfizer, NYSE, PFE, $24.86 has raised the dividend again, this time by 9% to $0.24 a share per quarter. The new annual yield is 3.8%. I am keeping a buy rating on Pfizer.

Rite Aid, NYSE, RAD, $1.35 shocked analysts with a third quarter profit of $0.07 a share. Analysts were expecting a loss. Rite Aid has now grown EBITDA for eight straight quarters and is in position to become profitable. Super-storm Sandy did hurt Rite Aid. The fourth quarter will likely show another loss. For the next year, management expects further improvement and possibly a small profit. It is too soon to buy more. My rating on Rite Aid is hold.

SEI Investments, NASDAQ, SEIC, $23.36; Joseph Ujobai, senior vice president, bought 5,000 shares of SEI on the open market on December 17, 2012 at an average price of $22.56 for a total of $112,800. Joseph Ujobai obviously does not agree with those who think the stock is overvalued. Quite the opposite - he thinks there is a profit to be made in the shares. On December 27, SEI will pay an extra dividend of $0.32 a share. That will be

combined with the regular semi-annual $0.16 a share dividend for a total of $0.48 a share. The extra is welcome - all the more so if the tax rate on dividends rises in 2013. I rate SEI a buy with a $30 twelve month stock price target.

CLOSING THOUGHTS

Do we have a spending problem or a revenue problem?

In the days and weeks leading up to the fiscal cliff, the Speaker of the House, John Boehner did his best to argue that the country has a spending problem, not a revenue problem. His charts and talking points got very little media coverage. What we constantly heard was that the President wants tax rates to go up and the Republicans object. “Tax the Rich” is always a popular idea, even though it never produces the expected results, and often hurts the economy.

There is no doubt we have a federal government spending problem. Federal outlays are up 27% since 2008. They are also up significantly as a percent of GDP, 21% in 2008 to 24% last year. Clearly, the economy will suffer if Federal spending keeps growing at current rates. For our long term health, Federal spending needs to be cut back to less than 20% of GDP. That could happen without actual cuts in spending if the economy were to grow faster than government spending. However, over the last four years the economy has grown at rates far below the growth in government spending.

For more details on government spending go to the website for the Tax Policy Center: www.taxpolicycenter.org

I spent a good deal of time searching the web for details on the revenue side of the question. Finally I found all the details I needed, in the last place I expected: the White House’s own website. www.whitehouse.gov/omb/budget/historicals

Table 2.1 provides historical and current data on federal receipts by source. The data show there was a steep, 23% decline in individual income tax receipts from 2007 to 2010. The fall in corporate tax receipts was even greater - 48%. Total tax receipts, however, were down a more modest 16%. Receipts from excise taxes, and other sources held up during the recession. Some categories actually increased between 2007 and 2010. The number

that really counts is the decline in total receipts. A fall of 16%, during the worst recession since the great depression, is less than I expected, and far less than you would think from the political rhetoric and media headlines.

Since 2010 there has been a remarkable recovery in individual and corporate tax receipts. Individual income tax receipts are up 30% from the 2010 low. Corporate tax receipts are up 24%. The peak for receipts from individuals was 2007. The data indicate that when all the numbers are counted, the amount the federal government collected in taxes last year from individuals will be a new record high, slightly above the 2007 peak and growing at a 7% annual rate.

Looking at all the data, I conclude that we do not have an individual tax revenue problem. The President and his supporters argue that we do have a revenue problem because total revenue was down to 15.4% of GDP in 2011. It was 18.5% of GDP in 2007. They want revenue to get back above 17% of GDP. As we know their answer is to ignore the details and increase tax rates on "the rich."

The lesson from looking at the tax details is that the only way to increase revenue as a percent of GDP is to create more jobs at higher wages and to increase the overall rate of economic growth. Raising tax rates on individuals - even if the rise is confined to "the rich" - is risky. Individuals and their collective activities as investors, entrepreneurs, and consumers are the source of growth in the economy. Raising tax rates will reduce savings and investment. That will hurt consumption. There is always a price to pay for raising individual tax rates.

France's socialist president tried to impose a 75% tax rate on incomes over one million euros ($1.32 million). A French court has ruled that tax rate to be unconstitutional. In terms of income taxes, that makes France look like a more civilized country than the United States. We have had tax rates as high as 90%. Arguably, the President's recent proposal to impose a tax rate of 43.4% on incomes over $250,000 is a more onerous tax than 75% on incomes over $1.32 million. The President's tax would hit many more individuals and could mean a forced change in living standards for families in expensive cities like New York or San Francisco. Perhaps we need to amend our constitution to include limits on how much the government can confiscate in income taxes.

Next issue: The February issue of *John Dessauer's Outlook* will be ready on Wednesday February 6, 2012.

Next weekly hotline: Wednesday January 9, 2013

NOTICE: Along with an impressive list of other speakers I will be at the *WORLD MONEY SHOW,* ORLANDO, FLORIDA, Jan. 30-Feb. 2, 2013. I will have two workshops on Jan. 31. I hope to see you there. Register free through this website:

https://secure.moneyshow.com/msc/twms/registration.asp?sid=twms13&scode=029913

All the best,

John Dessauer

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