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MARKET CALLS

2013 Outlook: Think Globally, Shrink Locally

Monday, January 14, 2013

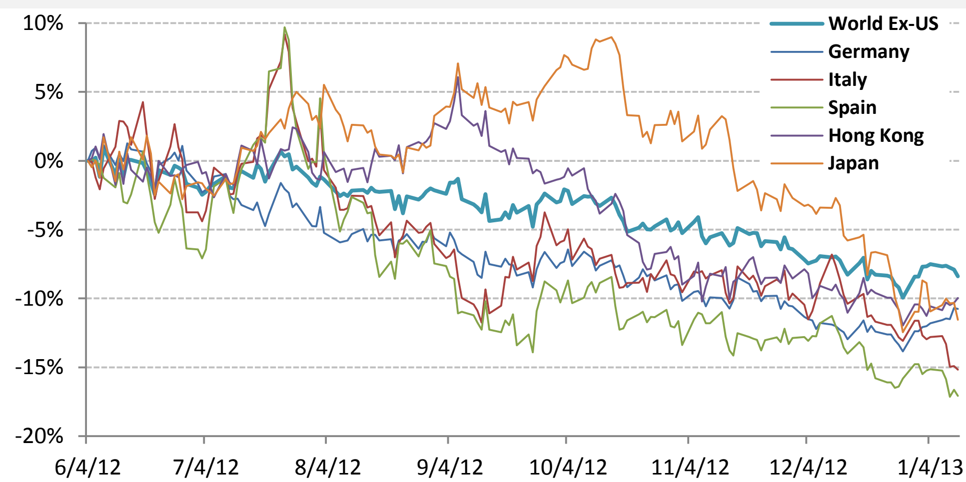
Donald Luskin

US stocks will pay as we move off the supply side, and the rest of the world moves toward it.

After the fiscal cliff crisis the S&P 500 hasn't quite made it back to the September highs, where we called the top (see "On the September FOMC" September 13, 2012). We still think it's mostly a relief rally, and of dubious longevity (see "Tax Hikes Have Consequences" January 2, 2013). *But what a relief* -- after a brief false alarm at year-end, volatility has fallen to its lowest level in 5-1/2 years. So for the moment, it feels like stocks want to keep melting up. But let's look ahead to the prospects for 2013.

- Aside from having survived the cliff, US stocks should benefit from a more benign global economy, free for the most part from the existential threats in Europe and China that dogged prior years.
- But US stocks are unlikely to be the *prime* beneficiary of this improved environment. The best performance should accrue in economies that have fundamentally realigned themselves for stronger growth. All the US has done is averted what would have been a self-created catastrophe -- at the price of the self-inflicted wound of higher taxes on everyone, rich and poor (again, see "Tax Hikes Have Consequences").
- Already US stocks have been at the back of the pack, globally -- even giving them the advantage of starting the measurement at their very bottom early last June (please see the chart below).

S&P 500 relative performance Rebased at 2012 closing low on June 4



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, EUROPE STOCKS, ASIA STOCKS: US stocks are at a new all-time high on a total return basis, yet they have strongly underperformed the rest of the world since the June 2012 bottom. With the cliff behind us, and a more benign global economy, 2013 should be a decent year for US stocks -- subject to getting through the political risks of the first quarter. But stock markets in Europe and Asia, where politically difficult fundamental supply-side reforms have been put in place, should perform better. The US has hardly begun to make necessary reforms -- and now we have saddled ourselves with higher taxes that will be punishing on the supply side and the demand side.

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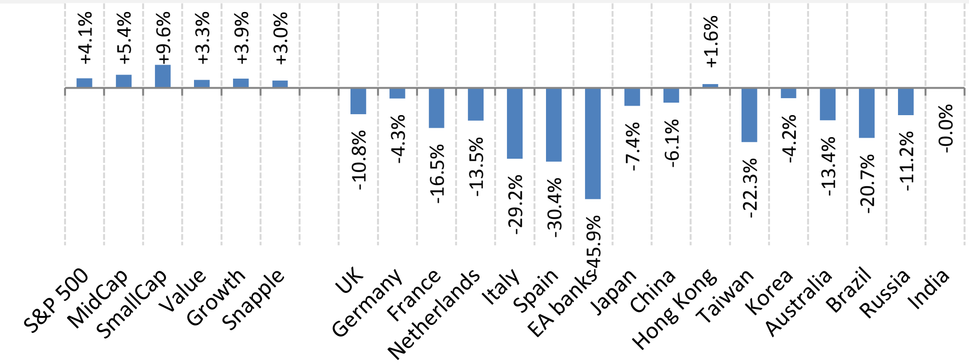
- This has been a large counter-move against a trend of US outperformance that began at the top of the last business cycle in late 2007.
- There isn't a lot of improvement so far in 2013, with the cliff crisis solved. We think relative underperformance by the US will generally continue throughout the year.
- In a more benign global economy, the US stands to gain the least -- having already gained the most. Except for Hong Kong, only in the US are forward earnings per share higher than their 2011 peak (please see the chart below). While much of the rest of the world can enjoy a cyclical rebound, the US will struggle with diminishing returns.

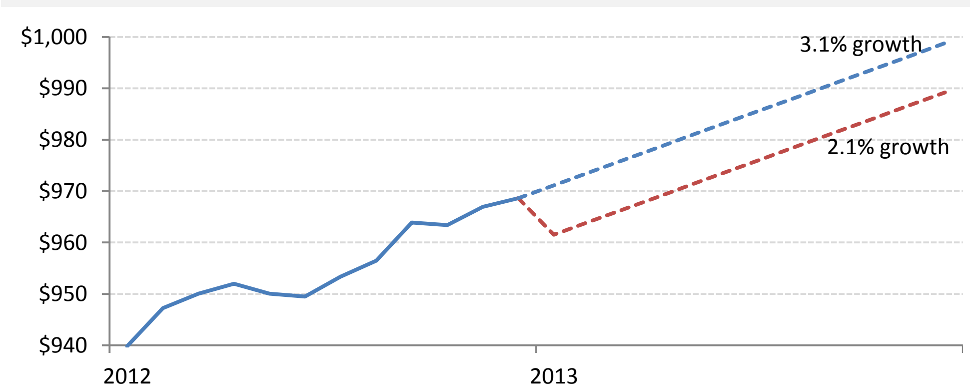
Change in forward EPS from respective 2011 peaks



Source: Bloomberg, TrendMacro calculations

- At the same time, the US has saddled itself with higher taxes which will have important demand-side and supply-side effects.
- The end of the payroll tax "holiday" means a more than 2% cut in take-home pay for most workers. The first pay packets of 2013 reflecting this reality are just starting to be received, revealing the opposite of relief in the American Taxpayer Relief Act of 2012 (ATRA).
- On the demand side, this will reduce growth in nominal personal consumption expenditures growth by about 1% in 2013 (please see the chart below).

Monthly consumption USD billions **Forecasted with holiday** **Without**



Source: BEA, TrendMacro calculations

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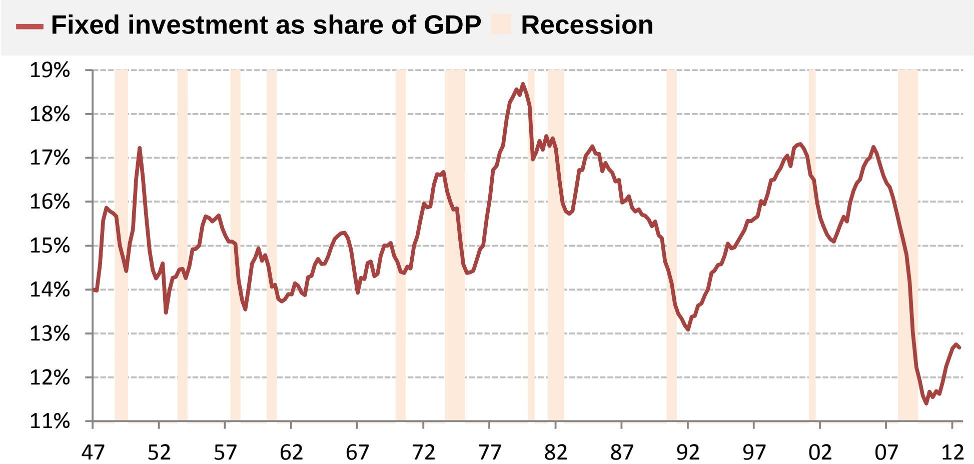
[About us]

Recommended Reading

Tax Provisions in The American Taxpayer Relief Act of 2012 (ATRA)
James Nunns and Jeffrey Rohaly
Urban-Brookings Tax Policy Center
January 9, 2013

[Reading home]

- On the supply side, this lowers the incentive for workers to supply their labor to the market. By perpetuating extended unemployment benefits, ATRA also raises incentives for workers to withhold their labor from the market, and instead to consume subsidized and tax-free leisure (again, see "Tax Hikes Have Consequences").
- Higher top tax rates on capital gains and dividend income increase disincentives to investment and risk-taking by lowering their after-tax returns. This comes at a time when fixed investment as a share of GDP has barely recovered from the all-time lows seen in the Great Recession (please see the chart below).



Source: BEA, TrendMacro calculations

- Meanwhile, while the US makes these policy errors, the rest of the world is getting it generally right, or at least moving in the right direction.
- The nations of peripheral Europe -- lacking reserve currency status, and lacking national central banks to buy their debt -- have been forced to reduce their deficits and implement politically difficult supply-side reforms in labor and product markets (see Lorcan Roche Kelly's reports over the last year and a half).
- China -- in yet another improbably deft move for a command-and-control economy -- has reined in the property bubble and runaway inflation it was facing a little over a year ago, and apparently without a hard landing.
- Japan's new government of Prime Minister Shinzo Abe continues to publically browbeat the Bank of Japan to adopt a hard intermediate-term target of 2% inflation -- finally joining the rest of the world's central banks after more than a decade of outright deflation and consequent currency appreciation.
- Here, in the US, we are going to hold back a weak labor market in the name of maintaining the fiction of the Social Security Trust Fund, and tax much-needed investment in the name of income equality -- and do nothing whatsoever about *spending*, the driver of the very real threat of growing deficits and debt.
- The US has had the luxury of avoiding dealing with the politically difficult spending problem because we have the world's reserve

currency, and a central bank that has not flinched from exploiting that position.

- Indeed, the very fact that the rest of the world has had to face up to politically difficult realities has enabled us to deny our own -- we've been the safe haven for their capital flight. So while on the face of it the US can benefit from a more stable global economic environment, that environment is in its own way also to some extent a headwind. The flight of capital to the US is over -- it can safely head home now.

This is not meant to be understood as a bear case for the US -- only relatively so.

- Yes, we're in for more political turbulence as the debt ceiling, the sequesters and the continuing resolution get debated this quarter. There's real risk there. We'll be watching headline by headline -- a real bear case may yet evolve.
- The risk here is *not only* that of a volatility event arising from extreme political brinksmanship, at worst resulting in a US Treasury default. That is a possibility to be respected and feared, but the longer-term and more fundamental risk is that the Republican party has lost internal coherency around pro-growth policies. The cliff debacle already shows that GOP is presently unable to effectively articulate advocacy for such policies (see "How the GOP Could Survive the Cliff" December 10, 2012). And its convictions were so thin as to be overcome by the most elementary blame-game tactics (see "What If the GOP Caves?" December 3, 2012). Perhaps that was because the GOP has now evolved into the party of debt-reduction, no longer the party of growth. Now with three debt-related political choke-points coming this quarter, we'll see if the GOP is the party of anything useful at all. If it turns out not to be, we face a prolonged period of retrograde policy with no effective opposition -- a period of no voice in government for growth.
- All that said, the cliff is indeed behind us, and for better or worse the US individual tax code has been stabilized. Housing is recovering, the Fed is easy, an energy revolution is ours for the taking, and systemic threats from abroad have abated.
- But given that we've just saddled ourselves with higher taxes that will be punishing on the demand side and the supply side, we don't see all that adding up to a bull case much more exciting than more of the same Not So Great Expansion.
- In Europe and Asia tough problems were substantively tackled, and new platforms for growth have been created.
- We think capital this year will flow toward those growth platforms -- and where policy is making capital more welcome, not less welcome.

Bottom line

US stocks are at a new all-time high on a total return basis, yet they have strongly underperformed the rest of the world since the June 2012 bottom.

With the cliff behind us, and a more benign global economy, 2013 should be a decent year for US stocks -- subject to getting through the political risks of the first quarter. But stock markets in Europe and Asia, where politically difficult fundamental supply-side reforms have been put in place, should perform better. The US has hardly begun to make necessary reforms -- and now we have saddled ourselves with higher taxes that will be punishing on the supply side and the demand side.