2013 A LOOK AHEAD

December 2012

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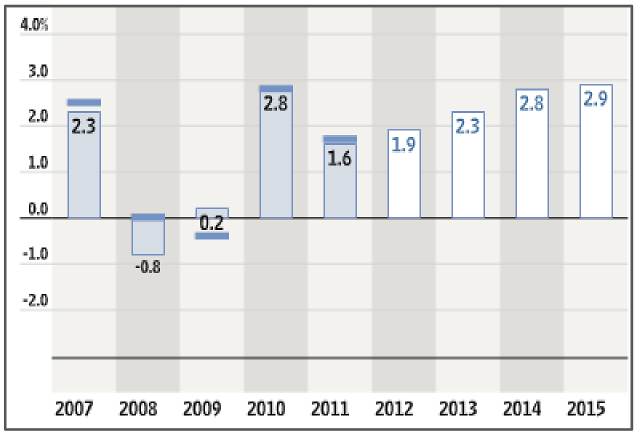
Economists see unemployment declining gradually to 7.0% over the next two years according to the Wall Street Journal. This combined with continued economic growth is relatively supportive of reasonable expectations for investment markets.

Consensus Real Gross Domestic Product Growth Rate



Source: Wall Street Journal as of December 12, 2012.

Of course, many other factors are at work. In the year ahead, we believe the following to be of particular import:

- Fiscal Headliners
- Epic Monetary Policy
- Low Interest Rates
- Reasonable Equity Market Valuations

Fiscal Headliners

Two items that may impact markets relate to the Debt Ceiling controversy and Sequestration.

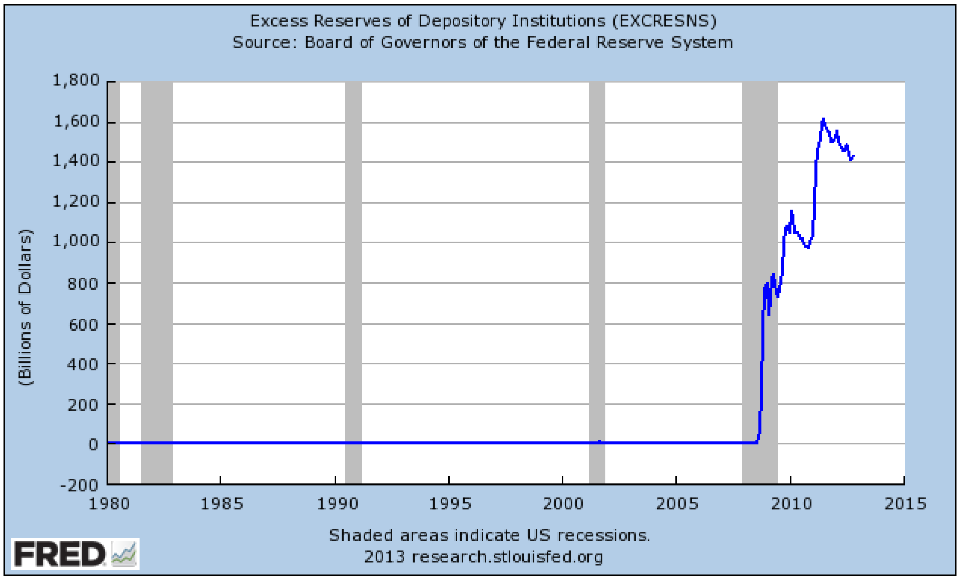
We find it unlikely that Congress would allow a situation where the government is forced to default on payments for any significant period of time. As a result, the Debt Ceiling controversy will certainly grab headlines but will be resolved favorably – having less impact on the markets than the last go around in 2011.

In the Budget Control Act of 2011, sequestration was used as a tool to control the federal budget. In part, it called for $1.2 trillion of specific spending cuts over nine years, starting in mid-2013. Today, many politicians are arguing to renegotiate this. At the time of this writing, the fate of the upcoming spending cuts has not been decided. Without any changes, sequestration amounts to $109 billion per year. According to the Bipartisan Policy Center, this would shave an approximate 0.5% off of economic growth. Therefore, even in the event that sequestration occurs, a recession remains unlikely. However, the markets could find reason to pullback for fear of its economic impact. In the end, a market correction would prove temporary and perhaps opportunistic.

As a result, we expect fiscal policy to be more of a headline risk for 2013 than a serious threat.

Epic Monetary Policy

The Fed has recently committed to buying $85 billion a month of Treasury and mortgage-backed bonds. This adds to over $1 trillion in assets per year. Considering the Fed never held $1 trillion in assets on its balance sheet until 2009, this is a big deal. Currently, the Fed holds approximately $2.9 trillion in assets. After required reserves, this means that its member banks have $1.4 trillion in excess reserves.



One of the byproducts of excess reserves is excess lending capacity. Lending capacity in the banking system is abnormally large as defined by traditional economic analysis. Specifically, additional money supply from lending capacity can be defined as initial Excess Reserves times the Money Multiplier. With Excess Reserves at $1.4 trillion and a Money Multiplier (as defined by 1-divided-by-the-Reserve-Ratio) at approximately 10, potential lending activity is exceedingly large.

In reality, future lending activity won't reach its massive potential. Well before this potential is reached, we would likely see plenty of economic growth with an uncomfortable pick-up in consumer prices. As the economy begins to overheat, the Fed has plenty of tools to reverse course. Therefore, the current Fed policy goal is to offer a fertile environment for a pick-up in activity.

Further, excess reserves are currently generating revenue for banks. In essence, banks are being paid to idle cash. While this has no doubt been quite therapeutic to the potential loss of capital from questionable loans, it has not provided an incentive for banks to make new loans. Despite this, commercial and industrial loan growth has risen 13% over the past year. The Fed could easily eliminate this policy should it want to stimulate more lending.

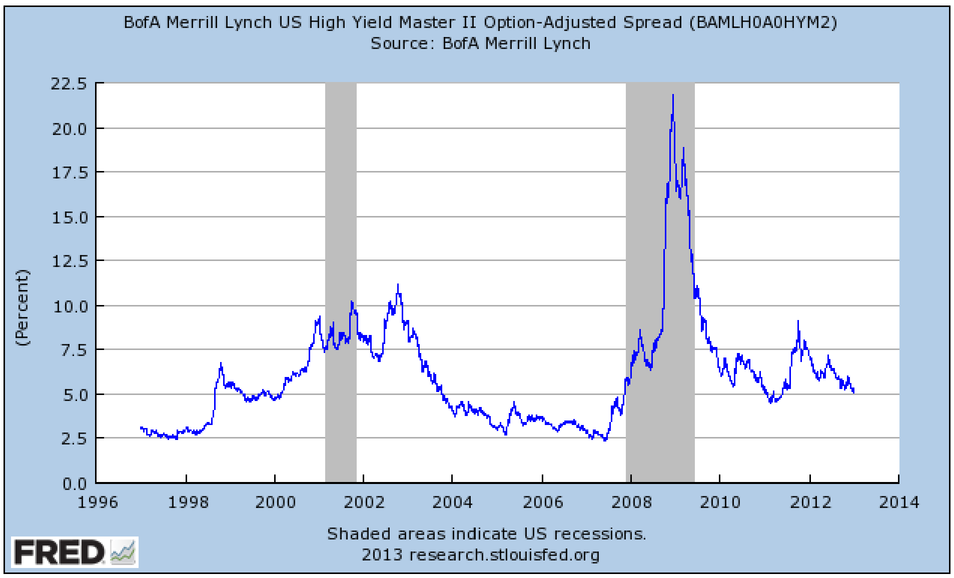
The last accommodative policy of note is that its zero interest rate policy (ZIRP) will be maintained for short-term rates until unemployment reaches a healthier 6.5%. Benchmarking ZIRP to unemployment is a new and bold commitment.

Taken together, an open-ended zero interest rate policy and aggressive security buying program will continue to have an impact on markets – as will the eventual reversal of these policies. The bottom-line is that current U.S. monetary policy is quite supportive of bond and equity markets through most of 2013 and possibly longer.

Low Interest Rates

Interest rates are historically low and could stay low for a long time as has been the case in Japan (past 20-years) and in the U.S. from the early 1940s to the mid-1950s. When the supply of bonds exceeds the currently excessive thirst for bonds, rates will rise. When expectations for economic growth and inflation rise enough, investors will require higher yields - and the Fed will want to increase short-term rates.

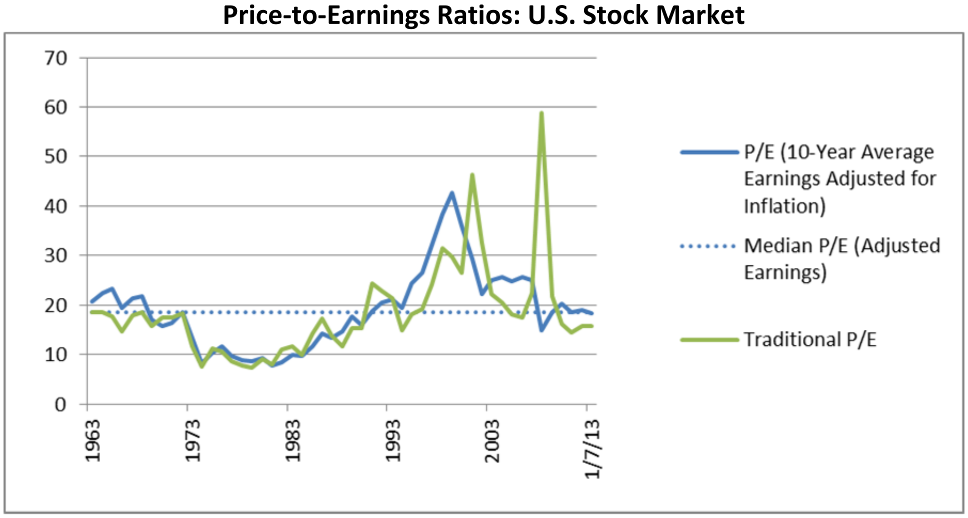
Since risk-free rates (i.e. Treasury rates) are less than inflation, income seeking investors have to take risks to keep up with inflation. This theme will likely continue throughout 2013. Eventually, an uncomfortable risk-reward payoff for some higher-risk markets (such as high-yield bonds and leveraged securities) could develop. Therefore, it will be constructive to monitor yield-spreads for high-yield bonds versus Treasury bonds, for example. Currently, spreads are still normal (see chart).



Reasonable Equity Market Valuations

The stock market's price-to-earnings ratio provides a reasonable indication of the stock market's price levels. Currently, it appears that the stock market is approximately in line with historically normal times. This seems to indicate a reasonably normal price level for the market.

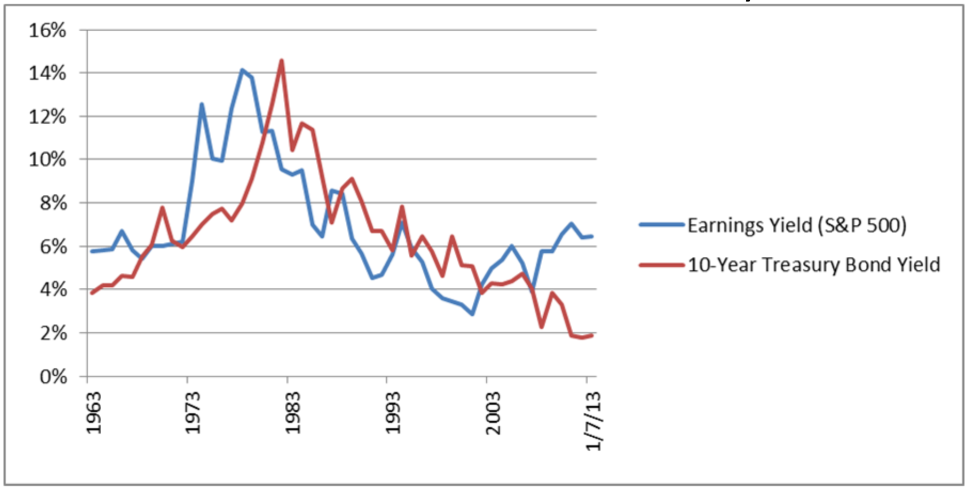
Price-to-Earnings Ratios: U.S. Stock Market



Source: Standard and Poor's, Robert Shiller.

On the other hand, compared to yields in the bond market, the equity market is rather cheap. Typically, the S&P 500 earnings yield (earnings divided by price), remains rather close to the U.S. 10-year Treasury Yield. As has been the case for the past three years, earnings yields have been attractive.

Valuation of U.S. Stock Market versus U.S. Treasury Bonds



Source: Standard and Poors, Robert Shiller.

One way of looking at today's stock market valuation is that it's been in correction-mode since 1999 when we were at historic bubble levels. Since then, it has taken two major corrections to work off the excess. That has been a major headwind over the past dozen years. Fortunately, that headwind has effectively vanished. As a result of today's reasonable-to-attractive equity prices, we expect longer term returns to the more dependent on earnings growth and dividends versus valuation adjustments.

Conclusion

Investment markets in 2013 appear to be positioned to benefit from reasonable economic growth, abnormally accommodative monetary (i.e. Fed) policy, and reasonable valuations. Disruptions will most certainly occur. The stock market, for example, typically sees a 20% range in prices when comparing its yearly high to its low. There is no reason to believe 2013 will be any different in that regard. However, the positive factors seem to outweigh the negatives.