Richard Bernstein

Beyond the Fiscal Cliff

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Politicians love the spotlight, but it is very unfortunate that investors watch the show. The drama of the so-called "fiscal cliff" has scared investors, and led them to miss a very good year in the equity market (the S&P 500's total return was 16.0% during 2012 versus the long-term annual average of 11.8%). It appears as though Washington wants to continue to dominate the headlines, which means that it may be more important than ever for investors to downplay Washington's theatrics.

Here are some considerations for investors as they plan for 2013.

The US economy doesn't stink. In fact, it is reasonably strong.

Politicians love to claim that the economy is performing poorly, and that we "have to get the economy rolling." However, the latest GDP report of 3.1% over the past year is higher than the 30-year average of 2.9%. The US economy is actually growing faster than average!

Early-cycle sectors of the economy, such as housing and autos, have been showing marked improvement. Consumer confidence has significantly risen. Corporate profits have held up reasonably well despite a stronger US dollar and weakening non-US economies. Inflation remains very subdued.

Uncertainty is good!

Many have suggested that the "uncertainty" surrounding Washington and the fiscal cliff has deterred both financial and real investment within the US economy. This uncertainty, though, has tautologically translated into attractive equity valuations that, we feel, present investors with good opportunities. Has there ever been a time in US stock market history when investors were "certain" and equities were undervalued? We doubt it.

As we have previously pointed out, the S&P 500 is presently discounting 5-6% inflation for the next twelve months despite that inflation is currently less than 2%. This shows the level of fear among investors, but also shows to us the level of opportunity.

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"Austerity" will not necessarily hurt the economy and the markets.

Many commentators have mentioned that the coming fiscal "austerity" will hurt the economy and the financial markets. We are not convinced because bull markets are not always based on the combination of stimulative monetary and stimulative fiscal policy. For example, the 1982 bull market was based on very tight monetary policy (Chairman Volker aggressively tightened monetary policy to fight inflation) and very stimulative fiscal policy (the Reagan-era budget deficits which were, at the time, the largest peacetime budget deficits in history).

Fiscal austerity is bound to happen in some form over the next several years, but the Fed seems intent on keeping monetary policy loose. Without inflation and inflation expectations meaningfully accelerating, it is hard to see how the Fed would quickly reverse course.

Don't ignore the US Industrial Renaissance

In the December issue of *The Atlantic*, Jeff Immelt, GE's CEO, is quoted as writing that outsourcing is "quickly becoming mostly outdated as a business model…" (See, Fishman, Charles. "The Insourcing Boom". *The Atlantic*. December 2012.)

We continue to believe that US manufacturing companies will gain market share as the decade progresses, and this remains one of our favorite investment themes. Closing wage differentials, lower energy costs, cheaper distribution costs, and political stability are all factors that companies are increasingly considering when locating new plant and equipment.

Washington's theater is clouding, what we think is, one of the most interesting investment stories. We continue to favor small and mid-cap industrial and manufacturing companies.

We can't emphasize enough that we view Washington as a sideshow (perhaps a very adequate analogy!), and that investors might be better served by focusing on fundamentals rather than politics. History shows well that corporate profits and valuations, and not Washington, ultimately drive equity returns.

Those who focused on Washington's drama missed out on solid equity returns in 2012. The same could happen in 2013.

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