



# Bradley, Foster & Sargent, Inc.

## Quarterly Market Commentary

January 2013

### The Best of Times, The Worst of Times

It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way...

*A Tale of Two Cities*, Charles Dickens, 1859

We begin this investment commentary with a nod to Charles Dickens by applying one of the great opening sentences of any novel to the current economic and political situation in the U.S. And it is very apt. Despite the media hyperbole and the dire predictions that “the fiscal cliff” on January 1, 2013 might bring the end of the world as we know it (thereby fulfilling the Mayan prophecies about the apocalypse predicted to take place on December 21, 2012), the world did not end. In fact, stock markets globally did very well in 2012 and ended the year strongly on news that a “deal,” which would ameliorate the “fiscal cliff,” was reached in Washington. The stock market generally does well when economic or political results exceed the negative expectations of investors. Frequent predictions in 2012 of imminent catastrophe from the meltdown in Europe, U.S. debt ceiling issues, or a recession in China caused much investor anxiety. As a result, U.S. investors continued to take money out of their equity mutual funds in 2012 – for the 4th straight year. But, generally, when dire predictions do not materialize, stock markets advance. In 2012, most stock markets around the globe were up double digits, as countries did muddle through – politically and economically. And the markets in January seem poised to prove the skeptics wrong again in 2013.

Yet, is it not possible that investors are in a period of suspended disbelief about the depth and breadth of problems confronting the American experiment? The year-end “deal” in Washington barely addressed the enormous U.S. annual budget deficit of \$1.1 trillion or the ballooning national debt, which is now 105% of GDP. The U.S. ship of state appears to be on an unsustainable course. The U.S. government continues to borrow almost one out of every three dollars it spends. Perhaps even more worrisome, our society appears to be growing more dependent on government each year; currently, almost half our citizens receive income or benefits from Washington. What happened to the land of opportunity where rugged independence was the hallmark of American character? Is this economic recovery and bull market perhaps an illusion? In this commentary, we will try to square the circle of economic growth and wealth creation resulting, in part, from mounting government debt and accelerating entitlement programs.

### The Best of Times

There are a number of very positive trends underway in the U.S. economy. The first is that the household debt service ratio is at its *lowest level in 29 years*. This measure, which includes both

mortgages and consumer debt, has been greatly aided by the record low interest rates engineered by the Federal Reserve Bank (Fed) and the wave of mortgage defaults and refinancing over the past several years. Auto sales are at the highest level in 5 years and sales should continue to rise, as the average age of the 245 million cars on the road in the U.S. is 11 years old. Housing prices seem to have bottomed last year, as the Case-Shiller Index showed a broad rise of almost 5% in average U.S. housing prices in 2012. New housing starts are increasing, which will add to GDP in 2013. Another very positive trend is the sea change underway in U.S. energy production. Crude oil production in the U.S. is at the highest level since 1997, having risen 15% last year. Moreover, the production of large amounts of shale gas has kept natural gas prices very low, providing a competitive edge for U.S. manufacturers and energy users vs. foreign manufacturers. For example, the current cost of natural gas in the U.S. is \$3.14 per Million Btu, compared with \$16.49 in Japan. This competitive advantage has led some multinationals to build new manufacturing facilities in the U.S. rather than abroad. Finally, most U.S. banks are healthy again, having boosted their capital ratios and shed non-performing loans. Despite headwinds of higher taxes and regulation, it is likely that the U.S. economy will continue its path of slow growth with real GDP growth of 2-3% in 2013 – assuming the debt ceiling negotiations are settled in reasonable fashion.

Previously, we have written that it is helpful to think of the stock market as a three-legged stool. One leg of the stool is the growth of corporate earnings; the second leg is interest rates; and the third leg is investor sentiment or psychology. The seat is the market's valuation or market multiple. The three legs of the stool look like this:

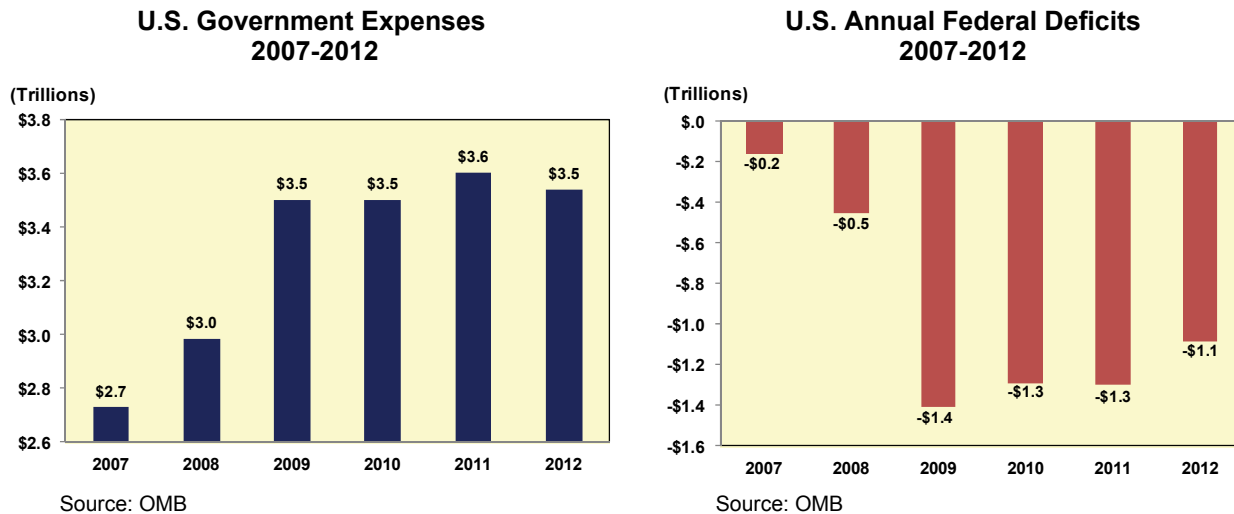
First Leg	Second Leg	Third Leg
<b>Corporate Earnings</b>	<b>Interest Rates</b>	<b>Investor Sentiment</b>
<i>Influenced by:</i>	<i>Influenced by:</i>	<i>Influenced by:</i>
U.S. economic growth	Inflation	Liquidity
Global economic growth	Monetary policy	Monetary policy
Technology	Fiscal policy	Fiscal policy
Productivity growth	Strong currency	Flow of funds
Fiscal & monetary policy	Political stability	Political climate
Business sentiment		Foreign demand
Consumer sentiment		Global political/economic events

The first leg of the stool has rarely been stronger. Estimated S&P 500 operating earnings for 2012 are forecast at an all-time high of \$99. This is 14% higher than the \$87 at the peak of the previous economic cycle in 2006. The seven biblical years of famine, unleashed by the near systemic failure of the U.S. financial system in 2007-2009, are coming to an end. S&P operating earnings for 2013 are estimated to grow more than 10% to \$112. Multinational corporations with great brands have strong balance sheets and cash flow, extraordinary liquidity, and excellent growth prospects. The second leg of the stool is also well-positioned to support the stock market. Interest rates are lower than at any time since World War II, and the Fed has pledged to hold down rates, to the best of its ability, until 2014 – although a growing chorus of Fed governors is calling for the Fed to begin to allow short-term rates to rise slowly to a level above the current 2% rate of inflation. Nonetheless, the second leg of the stool should remain strong for the foreseeable future. The third leg of the stool is decidedly wobbly – primarily due to fiscal and monetary policy emanating from Washington. However, as the

U.S. budget deficit should improve marginally in fiscal 2013 from \$1.1 trillion to approximately \$1 trillion or slightly less, the trend, at least, is positive even as the absolute numbers are worrisome.

### The Worst of Times

With the “fiscal cliff” deal raising only \$150 billion in revenues (including the reset of Social Security payroll taxes at 6.2%), the charts below show the gravity of the U.S.’s fiscal problems:



The U.S. Federal Debt has grown from \$10.6 trillion in January, 2009 to \$16.4 trillion on January 9, 2013 – an increase of 55%, or \$5.8 trillion, in four years. Many observers would agree that the large deficits incurred in 2009 and 2010 were largely justified to deal with the Panic of 2008-2009 and to overcome the severe recession during the same period. But the huge deficits and resulting increase in Federal Debt over the past several years are the result of bitter political warfare in Washington. The country is nearly evenly divided between the left and the right, and each has a very different vision of the direction in which America should proceed. The left wants to expand the role of government and not only safeguard entitlement programs but expand them. The left’s position is that increased government spending is necessary, and adequate revenues to fund this can be found by raising taxes. The right wants smaller government and less spending (primarily through capping and curtailing some entitlement programs). They believe that a reformed tax code and less regulation will produce a more rapidly growing economy similar to the period of 1982-1999, when 44 million jobs were created. They also believe that five more years of our current fiscal policies will saddle the U.S. with a worse Debt/GDP ratio than that of the struggling economies of Italy and Spain.

### Monetary Woes

To prevent the failure of the financial system during the Panic of 2008-2009 and to combat the deflationary forces unleashed by it, the Fed provided massive amounts of credit to the country’s financial institutions and then began a long-term program of buying U.S. debt (including large amounts of government guaranteed mortgages). For example, in 2011, the Fed bought 61% of all the U.S. Treasury obligations issued that year. Since the Panic of 2008-2009, the Fed has more than tripled the size of its balance sheet as the chart on the following page shows:

### Size of Federal Reserve Bank Balance Sheet 2008-2012



Source: Bloomberg

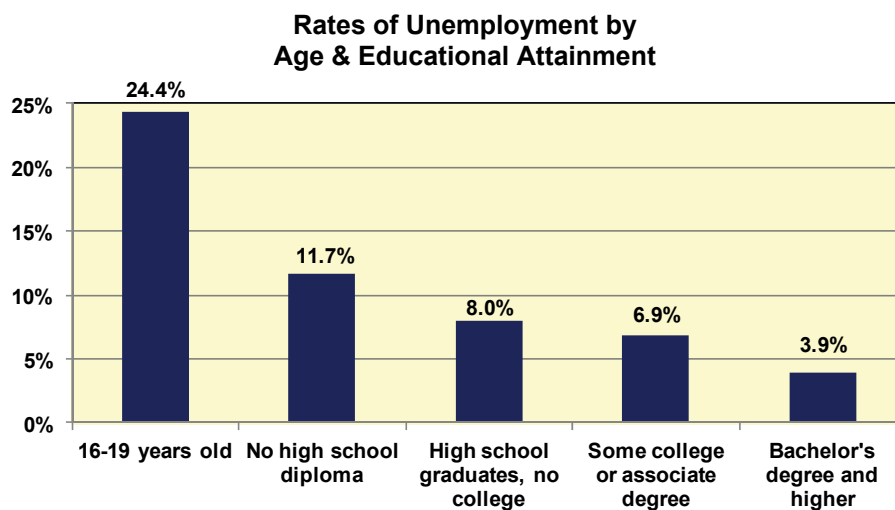
The Fed's aggressive actions in 2008-2009 were effective in avoiding the systemic failure of the U.S. banking system. And, with the exception of the bailout of GM and Chrysler, TARP worked, too, and will provide a handsome profit to the U.S. Treasury. During these years, the Fed brought interest rates to their lowest level since World War II. The Fed's steps helped bring the economy out of recession within six quarters. Their actions were also instrumental in helping banks repair their balance sheets and in assisting households in deleveraging. By reducing interest rates, the Fed helped to mitigate the decline in housing prices and supported prices in the stock market. However, the continuation of this low interest rate policy has enabled the executive and legislative branches of the government to continue running enormous fiscal deficits, since the cost of borrowing is so low. The interest expense on the Federal Debt this year will be approximately \$325 billion. This is less than 10% of Federal spending, as the average interest rate on the Federal Debt is roughly 2%. However, what happens when interest rates rise to 5-6%, as they inevitably will? The interest cost on the ballooning Federal Debt currently being incurred will become a crushing burden on the American taxpayers, rising perhaps to \$800 billion or \$1 trillion annually. The longer the Fed continues its low interest rate policy, the more challenging the situation will be for the nation – especially for future generations who will have to deal with the interest cost on the mounting debt.

### America: The Entitlement Society?

So what is driving U.S. Government spending up so rapidly? There are many culprits but not necessarily the usual suspects. Social Security, Medicare, and Medicaid will pose enormous fiscal difficulties over the next several decades, but they have not caused annual Federal spending to increase from \$2.7 trillion in 2007 to \$3.7 trillion over the past 5 years. Neither has an increase in defense spending. One of the key drivers of increased spending is the large increase in the number of individuals who are receiving benefits from food stamps. The Supplemental Nutrition Assistance Program has risen from 28 million recipients in 2008 to 47 million in 2012. This means that 15% of the U.S. population is currently on food stamps – 19 million more people than in 2008. There are surely many reasons for this, but a major contributor to this is the increasing rate of births to unmarried women. In 1964, shortly before Patrick Moynihan, later the great Democratic senator from New York, wrote his famous essay on the breakdown of the American family, births to unmarried women were 6.8% of all births. By 2010, this number had increased to over 40.6%. This is a hot topic that goes largely unreported, but there is little doubt that the increase in homes

without fathers has enormous societal consequences as well as financial implications. While heroic efforts are made by single parents, and often with great success, the empirical evidence shows that two-parent families mean less poverty, stronger schools, and stronger communities. As Michael Novak has written, the family is the first, best, and original Department of Health, Education and Welfare. In the absence of strong independent families, the State becomes the primary provider, which has many social consequences and can lead to severe fiscal difficulties.

Another problem area which slows wealth creation in the U.S. and often leads to income inequality is the state of high school education. High school dropouts pay a high price both in trying to secure employment and in lower lifetime earnings. And the graduation rate for high school students, especially for boys, is low, ranging from 57% to 81%, depending on race and ethnicity. As can be seen from the chart below, this influences the rate of unemployment, another contributor to large budget deficits:



Establishing proper financial incentives plays a major role in changing behavior as well as a country's finances. A decade ago, the German Chancellor Gerhard Schroeder led an overhaul of Germany's system of unemployment benefits. Benefits were reduced to a maximum of 52 weeks. The result was that Germany's unemployment rate, which for decades had been perennially higher than in the U.S., dropped dramatically. In contrast, unemployment benefits in the U.S. were extended from 26 weeks to as long 99 weeks over the past 4 years. Since 2008, Germany's unemployment rate has been consistently lower than here in the U.S., where the cumulative cost of unemployment benefits has run to many hundred billion dollars since 2008. While there are times to consider longer-term unemployment benefits, long-term solutions need to balance incentives vs. needs.

There is not room here to describe how the U.S. has reached the point where nearly 50% of its citizens are receiving government money or benefits through its vast entitlement programs. But the purpose of this commentary is to draw attention to the fact that our increasingly dependent society is driving the financial cost of government entitlements and benefits. And this, in turn, is resulting in grave fiscal imbalances in our budget and the very financial stability of the nation. Accordingly, the Federal Reserve has sought to solve the fiscal dilemma by buying trillions of dollars of U.S. Government obligations and mortgages to hold interest rates down. This is a vicious cycle whose downward spiral threatens the U.S. both financially and socially.

## Summary

The U.S. budget deficit is big and unsustainable, driven in large part by the growth of our entitlement society. As political solutions have not been adopted in Washington to live within our means, the Fed has sought to solve fiscal problems with monetary measures. It has worked remarkably well over the last five years. This can be seen from the many positive features of the U.S. economy described above. However, if the U.S.'s Debt/GDP ratio continues on the same trajectory, a financial crisis will appear on the horizon. The recent "fiscal cliff" deal did little to solve the current fiscal imbalances. The debt ceiling negotiations currently underway appear less than promising, too. Yet the financial markets appear largely to be ignoring these issues. There are several possible explanations for this. One is that the U.S. dollar continues to be the world's primary reserve currency, and it doesn't appear as if the other candidates – the Japanese Yen, the Euro, and the Chinese Yuan – are in a position to replace the dollar as the primary reserve currency in the near term. This enables the U.S. to run large fiscal and current account deficits for as long as the U.S. dollar continues in this role. The other explanation is that the U.S. is a very wealthy nation. Private wealth is over \$60 trillion compared with the Federal Debt of \$16.4 trillion. Investors seem to believe that, one way or another, the U.S. will muddle through.

Last year, investors focused on the good news: the two legs of the stool that are in good shape – solid corporate earnings and low interest rates. In our view, if the third leg were strong, the S&P 500 very likely could be trading at around 1800 – 16 times the 2013 operating earnings estimate of \$112 (the average multiple for the S&P 500 over the past 40 years has been 16). The fact that the S&P 500 is trading at 13.1 times 2013 earnings can be attributed to the shaky third leg of investor psychology. With negative investor sentiment, it is quite possible that markets will behave in 2013 in much the same way as in 2012 – a slow but steady climb over the "wall of worry." There are signs that investor sentiment may be turning, too, as investors in early 2013 started to add funds to U.S. equity mutual funds, reversing the outflow over the previous years. It is our sense that investors in 2013 will continue to pay more attention to the "Best of Times," as detailed above, rather than the "Worst of Times." But there are many challenges to overcome in the U.S. and the possibility of a serious geopolitical problem arising in the Middle East or economic problems in Europe. Thus, our approach at Bradley, Foster & Sargent continues to be to focus on quality – companies with great brands, good balance sheets, and strong cash flow. They will stand investors in good stead in 2013.

## Bradley, Foster & Sargent, Inc.

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