2012: A Fourth Quarter Review

A quick summary of economies & markets for you.

While the S&P 500 had its first negative fourth quarter in four years, it didn't stop the index from having a great 2012. The NASDAQ and Dow also lost ground for the quarter, but the losses could have been worse – Europe was for once relatively free of alarm, Wall Street seemed to take fiscal cliff fears in stride, and key indicators held up even after a massive storm delivered a punch to the economy on the east coast. The Fed let investors know exactly where it stood when it came to raising rates. Our real estate sector showed real improvement. Congress added a whole bunch of drama – a deal was struck right at the edge of the fiscal cliff, one which provided a partial solution to the dilemma (as well as higher taxes).[1]

Domestic economic health. Congress technically missed the year-end deadline for addressing the fiscal cliff issue, but it managed a fix on New Year's Day – and the resulting tax law changes were major. A repeal of the 2% payroll tax cut meant higher taxes for working Americans across the board in 2013. The top marginal tax rate was reset to 39.6%, and the top estate tax rate was hiked to 40% while the individual exemption fell slightly to $5 million. The bill had a considerable upside: the Bush-era tax cuts were made permanent for 98% of Americans, unemployment insurance was extended for another year, and the idea of taxing dividends as ordinary income was jettisoned (the legislation capped both dividend and capital gains taxes at 20%).[2]

The Federal Reserve told the country exactly when it would make a move on interest rates. It said it would do so when the unemployment rate hit 6.5% or inflation reached 2.5%. Operation Twist expired at the end of the quarter, but the central bank said it would buy $45 billion in longer-term Treasuries come January. Reports out of Washington hinted that Treasury Secretary Timothy Geithner and Fed Chairman Ben Bernanke were considering leaving their jobs by 2014 or earlier; in fact, it looked as if Geithner would resign in January.[3,4,5,6]

By December, the jobless rate had declined to 7.8%, down 0.5% in five months; the long-term unemployed comprised 39.1% of jobless Americans, down from 44.3% two years before. Good news, yet the looming fiscal cliff stressed households. The Conference Board's consumer confidence poll and the University of Michigan's consumer sentiment survey saw big drops in December after reaching multiyear highs in November, respectively falling 6.4% and 9.8%.[7,8,9]

As for consumer spending, it was up 0.4% in November after a 0.1% October retreat. Consumer incomes rose 0.6% in November, the best advance in 11 months. In related news, the Bureau of Economic Analysis put the final estimate of Q3 GDP at 3.1%, a sea change from the initial 2.0% assessment. Retail sales decreased 0.3% in October, then rebounded 0.3% in November even with the effects from Superstorm Sandy (gasoline sales plunged 4% while automakers reported the best month of new car sales they had seen in four years).[9,10,11]

Consumer inflation was not yet a factor, even as QE3 progressed. In fact, the CPI declined 0.3% in November and only rose 0.1% in October. By November, yearly consumer inflation was just 1.8% (the annualized core CPI increase was 1.9%). Producer prices fell 0.2% in October and 0.8% in November after rising 1.1% in September.[3,12]

The Institute for Supply Management's manufacturing PMI again flirted with contraction territory – it was at 51.7 in October, 49.5 in November and 50.7 in December. ISM's service sector PMI was stronger: 54.2 for October, 54.7 in November and 56.1 for December.[13,14]

Global economic health. The outlook grew brighter for China in late 2012. HSBC's China PMI topped 50 in November (the first time that had happened in 13 months), and the International Monetary Fund forecast 8.2% growth for the PRC in 2013 (2012 was shaping up to be the poorest year for China's economy since 1999, with Q3 GDP at just 7.4%). The IMF projected overall 2013 Asia-Pacific growth at 6.0% for 2013, which was also its projection for India. While Australia's benchmark PMI came in at 44.3 in December, manufacturing gauges in China, South Korea and Taiwan all surpassed the 50 level.[15,16,17]

Europe's four-year-old debt crisis was hardly settling down. Bank lending to companies declined in the eurozone by 1.8% in both October and November; the European Commission approved a collective €37 billion rescue package for four key Spanish banks during the quarter. On the upside, S&P upgraded Greece's credit rating to B-. Germany's unemployment rate hit 6.7% in December. The Markit PMI for overall EU manufacturing sank below 47 in November and December, a strong hint that the eurozone recession would extend for a third quarter.[18,19]

very well, and the Nikkei 225 led them all with a 17.2% advance. Australia's All Ordinaries rose 5.9%, the Hang Seng climbed 8.8%, the Sensex rose 3.6% and the Shanghai Composite gained 8.9%. The MSCI World Index rose 2.1% for the quarter; the MSCI Emerging Markets index advanced 5.2%. Momentum also gathered in Europe. Here are some Q4 gains from that region: CAC 40, 8.5%; IBEX, 6.0%; FTSE 100, 2.7%; STOXX 600, 4.2%. Greece's ATHEX Composite rose 23% last quarter.[17,20,21]

Commodities markets. Generally speaking, the fourth quarter was rough on the commodities sector. In New York, silver and gold both dropped 12.6%; platinum fell 7.6%, yet palladium gained 9.8%. (Gold and silver did respectively advance 7.0% and 8.3% on the year.) The quarter was not good for some key crops: corn futures lost 7.3%, wheat 13.8%, and soybeans 11.4%. (However, wheat futures rose 19.2% across 2012 while soybeans gained 18.4%.) Natural gas futures soared in the quarter en route to a 12.1% yearly gain; oil's red Q4 contributed to its 7.1% 2012 descent. The U.S. Dollar Index ticked down 0.2% in Q4 2012.[22,23,24,25]

Real estate. Reporting a 5.9% gain in existing home sales in November, the National Association of Realtors also said residential resales had increased 14.5% in the past 12 months. October's Case-Shiller Home Price Index showed a 4.3% annual gain in home values across 20 cities – the best yearly advance it had seen in 29 months. Building permits for single-family construction were up 25.3% annually by November, with single-family housing starts up 22.8% in the past year. By November, median new home prices were 3.7% higher year-over-year; new home sales were down 3.5% in October but up 4.4% a month later. Pending home sales were up for a third straight month in November, rising 1.7%.[26,27,28]

Home loan rates descended in Q4 2012, with a helping hand from QE3. Back on September 27, interest rates on mortgages averaged as follows, according to Freddie Mac's Primary Mortgage Market Survey: 30-year FRMs, 3.40%; 15-year FRMs, 2.73%; 5/1-year ARMs, 2.71%; 1-year ARMs, 2.60%. In the December 27 PMMS, the averages were: 30-year FRMs, 3.35%; 15-year FRMs, 2.65%; 5/1-year ARMs, 2.70%; 1-year ARMs, 2.56%.[29]

Looking back … looking forward. In the following chart, note the 6.15% difference in the annual performance of the Dow and S&P for 2012. The gap hasn't been that broad since 2002. As a footnote, the Russell 2000 finished 2012 just 1.8% under its all-time closing high of 865.29 from April 2011; it rose 14.63% for the year. Another thing about the Russell 2000: it didn't lose any ground last quarter. The Dow, S&P and NASDAQ all beat notable retreats over the past three months. The Dow ended the year at 13,104.14, the S&P at 1,426.19 and the NASDAQ at 3,019.51.[1,30,31]

% CHANGE	2012	1Q CHG	2Q CHG	10-YR AVG
DJIA	+7.26	-2.48	+1.74	+5.71
NASDAQ	+15.91	-3.10	+2.88	+12.61
S&P 500	+13.41	-1.01	+4.70	+6.21
REAL YIELD	12/31 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	-0.67%	-0.07%	1.73%	3.10%

Sources: cnbc.com, bigcharts.com, treasury.gov, treasurydirect.gov - 12/31/12[31,32,33,34,35]
Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
These returns do not include dividends.

Is the worst behind us? Is the wind in our favor? Economists have talked for months about how the market could have a great 2013, if only a solution could be found for the fiscal cliff ... and Europe's debt crisis ... and the threat of higher taxes ... and so forth. Well, the market spent most of 2012 worrying about these things and had a good year anyway. Wall Street's optimism is pretty entrenched at the moment, and it may be bolstered in Q1 2013 if fundamental indicators continue to improve and earnings surprise to the upside. The faith in this bull market has yet to fade.

The opening three months of 2013 will hopefully offer investors a respite from the drama so prevalent in 2012. We will provide you with a review of the economic developments from Q1 in early April. Should you have any pressing financial questions or concerns in the meantime, feel free to contact us at 455.455.6623.

Sincerely yours,
Lars Knudsen & Dan Stober

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