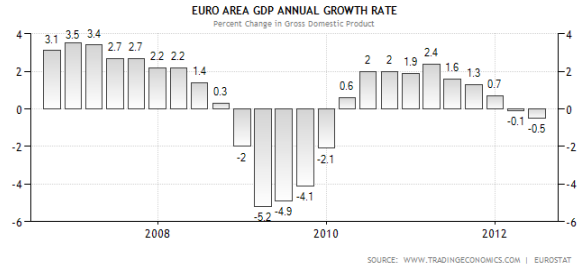


## US Economic Outlook

Look at the change in U.S. growth shown below **left**. Note especially the last six quarters. Then look at the change in European growth to the right and notice the trend over the same time.



Yes, the U.S. is doing significantly better than Europe but the U.S. and China do a great deal of trade with Europe. And, European bankers are normally very active in lending to companies around the world but are not in the best shape right now, losing money on loans tied to real estate and on government bonds to places like Greece, Ireland, Iceland and Portugal and worrying about Spain and Italy.

Considering that exports have provided half of U.S. economic growth since 2008 and that Europe is now in recession with China is slowing down more than had been expected, *one should expect that U.S. growth will also slow further.*

The Federal Reserve is not doing all it can do stimulate growth because it thinks things are fine. The Fed appears to be genuinely worried. The Fed says current growth is too slow (it wants 3%), inflation is too low (it wants 2%) and the unemployment rate is too high (it wants 5% - 6%).

## Corporate Profits



The chart at left shows **corporate profits** as a percentage of the economy. Corporate profits are at record highs. A longer chart would show that they are the highest ever.

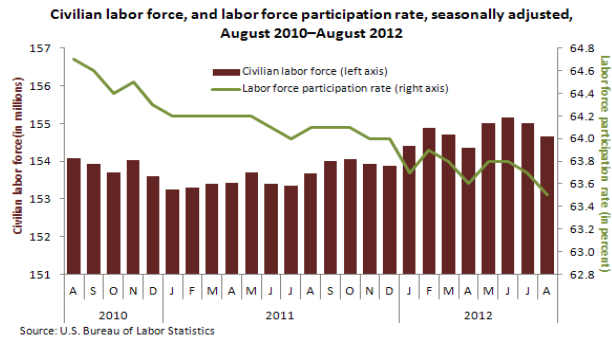
The **total savings** of U.S. households and the government is quarter is plotted too. You can see that since 1970 **corporate profits** have rarely been higher than **total savings**. More importantly, in each case it marked a peak and subsequent downturn in profits.

The 3<sup>rd</sup> quarter of 2012 will likely be the first quarter since 2009 that overall profits will shrink. *So, profits may be at a peak.* The increase in total profits since 2009 has been due largely to lower interest cost, layoffs, inventory cuts and delayed spending on expansion, items that have largely run their course. Sales growth has been mediocre for most companies. That is a potential problem because flat to lower

corporate profits are not normally associated with strong stock markets. Before I answer the question, “So, why is the stock market up so much this year in a disappointing economy with peaking corporate profits” let’s look briefly at unemployment.

## Unemployment

First, let me say once again that the 7.8% rate is not a good measure of unemployment because it does not count those who have given up looking for work as being unemployed. This makes no sense at all.



The better rate is the labor force participation rate shown at left. First, look at the **bars** showing the number of people between 16 and 65 working or actively looking for work. Missing are those who have given up looking. You can see that in early 2010 (at left) the labor force was 154.1 million and as of August 2012 only 154.7. This is an increase of 0.6 million in two and a half years.

During the same time the US adult population grew by 5 million, since it grows about 2 million per year (<http://forecast-chart.com/forecast-population.html>).

This means the increase in those working or seeking work badly lagged the increase in the adult population. Job-seekers are giving up and when they do they are no longer counted, either as part of the work force or as unemployed. The unemployment rate is thus lower than what it should be.

The fact that actual employment is lower is confirmed by the **green line** above. This shows the percentage of Americans over age 16 who are working. It has been declining for 30 years and the decline continues. In the last 2 ½ years the percentage of Americans working has dropped another 1.3%.

This decline is partly due to the Baby Boom generation starting to retire. But, if you have talked to many boomers lately you know that some are retiring against their will. They were laid off and their retirement savings are insufficient. Some are working part-time. You can see them at Lowe’s and WalMart. So, to pin the entire drop in the employment rate on retiring Baby Boomers is misplaced.

*Bottom line: the reported unemployment rate is not giving an accurate picture of how poor U.S. employment is at present.*

## Stock and Bond Performance



Through 9/30/12 the U.S. stock market is up 12% for the Dow Jones Industrials, 14% for the broader market and 16% for the S&P 500. The most aggressive bond categories like junk and emerging market bonds did best, though high quality has done well too. The Barclays Bond Aggregate Index was up roughly 4% through 9/30/12.

## Stock Market Outlook



It is interesting to note that stocks are up double digits for the year when you look at the chart of US economic growth at the start of this newsletter. It shows slowing economic growth, down to only 1.3% during the last quarter. You may naturally ask, “What’s going on here?” What is going on is a combination of three major factors.

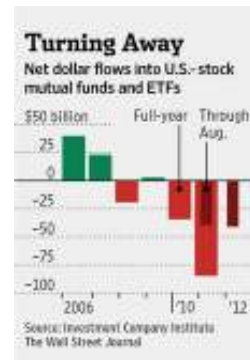
First, low interest rates mean relatively low returns for bonds and nonexistent returns for cash and CDs. Commodities have also performed poorly. Real estate has done OK. This means that *stocks do not have a lot of competition for the investment dollar*. This year, stocks win hands down.

Second, the US has been seen as the safest major stock market, particularly with the widely publicized European troubles and the strong slowdown in China. Overseas investors have apparently sent a good bit of money to the US stock market, giving it an extra boost.

Speaking of an extra boost, Ben Bernanke has provided extra liquidity for the banks. Instead of being loaned out in a weak economy with stressed applicants, banks have continued to put this gift into the stock market to earn higher returns. Recently Mr. Bernanke admitted that a stronger stock market is a goal because it tends to produce a wealth effect and produce greater spending. Take note and “*don’t fight the Fed.*”



So, the fundamentals are mediocre but cash flow into stocks has been strong. That cash has not come from mom and pop. The chart at right shows that the flow of dollars into mutual funds and ETFs, the main vehicles small investors use to invest in stocks is down sharply. That means money for stocks has been largely from institutions because institutions often invest in the individual stocks. That inflow of \$\$ has far outweighed the drop in money from individual investors. Economics 101 teaches that increased demand for stocks increases prices unless the supply of stocks increases accordingly, which it has not. BTW, on the chart, “Through August” should point at the far right bar, not 2011.



I do not see the economic fundamentals getting markedly better and maybe even getting slightly worse. But, as long as interest rates stay low, Europe stays punk and big money keeps preferring stocks, stocks should keep their ragged climb higher with uncomfortable setbacks along the way. Since late October through April tends to be the best time for stocks and U.S. economic data the last few years seems to be stronger in the winter than the rest of the year, I retain a hefty weighting in stocks for most portfolios.

## The Fiscal Cliff and the Presidential Election



So what about the dreaded “fiscal cliff” of expiring Bush tax cuts and reduced spending that is due early next year? Good question.

One mitigating factor is that government spending seems lately to have lost its

ability to stimulate the economy. That was predicted by a widely quoted academic study showing that fiscal stimulus begins to lose its effectiveness as government debt rises to 90% of GDP. As debt continues to rise, the stimulus effect continues to decrease. The U.S. debt to GDP is now over 100%. So, the decrease in government spending may not have as great an effect as many think.

One need only look at the weak outcome of all the extra spending over the last four years. As Exhibit A, several studies have shown that the \$787 billion spending bill of early 2009 was a flop, creating only about 200 jobs. That same \$787 billion could have been sent as a tax-free check of \$6,900 to every U.S. household.



On the down side, the top 2% - 3% of Americans are definitely going to have less to spend. Don't say you don't care because that group drove much of the economic growth the last three years. They will likely see big increases in taxes in 2013, not only in their tax rates but in much higher taxes on dividends and capital gains. I think this, combined with the drag from lower exports due to a slowing world economy, will be enough to slow U.S. growth close to zero. A shallow recession is possible in 2013.

I don't think this will become apparent before the presidential election next month and absent more surprisingly powerful performances by Mitt Romney in the remaining debates I expect President Obama to be reelected with a split Congress.



As the president famously told Russian President Medvedev thinking he was off-mike, "I can be much more flexible [read: freer] after the election." *Expect taxes and regulations*

*to increase over the next four years.* The real costs of ObamaCare will also kick in and the accounting gimmicks used to show it saved money will be shown for what they are. This is already happening, though you didn't see in on the evening news. See the Wall St. Journal article *ObamaCare's Costs Are Soaring* <http://online.wsj.com/article/SB10001424052702304724404577289363234579868.html>



### **Planned 2013 Tax Increases**

It is not too soon to do tax planning. Here are the biggest likely changes in tax rates for 2013, partly due to the likely expiration of the Bush Tax Cuts. Note especially the capital gains and dividend tax increases.

Type of Income	2011-2012	2013 Rate
Regular Tax Rates (top rate)	35%	39.6%
Long-Term Capital Gains	15%	20%
Qualified Dividends	15%	39.6%

In addition, there is a new 0.9% Medicare tax on wages/salary and self-employment income over \$200,000 for single taxpayers and \$250,000 for married taxpayers. This tax has no cap.

There is also a new surtax that is 3.8% that kicks in at \$200,000 for single filers and \$250,000 for those who file as *married filing jointly*. The surtax is levied on the lesser of the taxpayer's net investment income or the amount by which the modified adjusted gross income is over the threshold amount.

Consider doing the following in taxable accounts:

- Switching to growth securities versus dividend-paying securities or keep your dividend paying investments in a tax-deferred account like an IRA
- Using tax-free and tax-deferred investments
- Taking long-term capital gains in 2012 before the rate increases

*For IRA accounts, you should consider converting regular IRA accounts to Roth IRA accounts in 2012 before the new higher tax rates kick in. Once the investments are in a Roth IRA account they are generally exempt from further taxes, even on future growth.*

Of course, Congress could pull a last-minute deal to change the planned tax increases or Mitt Romney could come from behind to win the election and signal that these tax increases will be reversed.

### **Conclusion**

So, the news is poor and the markets are good. What else is new?

This confuses a lot of investors, especially those who invest on their own. Americans continue to pull money out of the stock market, as they have done every year since 2009. Much of this has gone to bonds; the rest likely has gone to cash and is earning nothing. Once again the individual investor lags far behind.

This is why people need professional investment help. If you know someone in this spot, I would like to help. Just ask if it is OK to have me call them and I will follow up. Thank you.

Dave Hoshour

Cornerstone Investment Services

3003 Thorndale Rd

Indian Trail, NC 28079

704-698-1040 work

704-488-4976 cell

[DaveH@CornerstoneInvestment.com](mailto:DaveH@CornerstoneInvestment.com)

[www.CornerstoneInvestment.com](http://www.CornerstoneInvestment.com)