INTRINSIC VALUE WEALTH REPORT™

ECONOMIC OUTLOOK

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OVERVIEW

Our view of the outlook for the U.S. economy is based on our analysis of the economy using the *Simple and Effective Economic Forecasting Model* developed by our firm. Accordingly, the analysis looks at the four components of the expenditure approach to the measurement of gross domestic product (GDP): (1) Consumption; (2) Business Investment; (3) Government Expenditures; and (4) Net Exports. Our analysis is also based on forecasts that are derived from a proprietary model that weights and adjusts forecasts made by professional economists in various periodic surveys including the *Survey of Professional Forecasters*, published by the Federal Reserve Bank of Philadelphia (www.philadelphiafed.org).

CONSUMPTION

U.S. companies have been investing increasingly in machines and technology, and less in labor. Timothy Aeppel of the Wall Street Journal said in January of last year: "In no other U.S. recovery since World War II have companies been simultaneously faster to boost spending on machines and software, while slower to add people to run them" (Aeppel, 2012).

Consumption is the key to economic growth. Comprising about two-thirds of gross domestic product (GDP), consumption is the single biggest driver of economic growth of the four components in the expenditure model of the economy. Until consumers are fully employed and confident, economic growth will be slow at best.

The consumer has not been very confident. The Conference Board's index of consumer attitudes fell in November to 70.4 from 72.4 in October. Consumers continue to spend only modestly due to worries about jobs and the economy. Thanksgiving sales this year were down for the first time in seven years. The Federal Reserve has expressed concern that further fiscal impasses, such as the one that led to the recent government shutdown, will weigh heavily on both business and consumer confidence.

A possible bright spot for the economy was a large increase in new home sales in October. However, home resales fell 3.2 percent in October to their lowest level since June due to an inventory shortage, high property prices, and higher mortgage rates.

As shown in our *Forecasts* table, unemployment is seen decreasing only moderately from an estimated 7.5 percent rate in 2013 to 6.0 percent in 2016 (which is closer to the so-called normal rate of unemployment of around 5.5 percent). But that is still a couple of years out.

BUSINESS INVESTMENT

The business sector, like the consumer sector, has had mixed results. By some measures, manufacturing may be improving a little, but for the most part the news has not been very good. Recently reported durable goods orders indicated marginally negative and sluggish manufacturing activity. The durable goods "core" number (nondefense capital goods, excluding aircraft) fell 1.3 percent from August to September. Capital equipment spending expanded at less than a 5 percent rate for the third quarter in a row.

Earnings have been strong, but there are indications there may be some slowing to come. Earnings were up 3.5 percent from a year earlier, while revenue growth was up only 2.9 percent. Companies have so far managed to maintain high profit margins due to aggressive cost cutting, automation, and lower commodity prices. Companies have record amounts of cash they are not willing to invest in this uncertain business climate.

GOVERNMENT

The big question is when the Federal Reserve (the "Fed") will taper off on its program of quantitative easing (QE). Janice Yellen, the incoming Chairman of the Federal Reserve, has made it clear that QE won't last forever; though some economists think she might keep QE in place longer than outgoing Fed Chairman Ben Bernanke would have. The Fed minutes show that there has been considerable discussion on when to taper off on QE. The Fed probably will taper off on QE in a manner consistent with their assessment of economic growth – and if there assessment is correct, the positive effects of economic growth should at least partially counter the negative effects brought about by reducing QE. This is if they are correct in their assessment – a big "if"!

The partial government shutdown in October is expected to subdue economic growth somewhat. But the bigger concern is the next round of possible battles coming up in January, when the government has to address the fiscal issues again.

NET EXPORTS

The other world economies have been experiencing slower growth, too. Japan's economy grew at a 1.9 percent rate last quarter, which was half the rate in the previous quarter. Slower growth has also been noted in Europe, China and India.

Adding to these problems, the U.S. dollar is up against several major currencies including Japan, Brazil, and India, making U.S. exports within those countries more expensive. On a positive note, U.S. exports hit a record high in October and the trade deficit shrank 5.4 percent to $40.6 billion in October, suggesting trade will help the U.S. growth number this quarter.

THE BOTTOM LINE ON GDP GROWTH

While it doesn't feel like it to most consumers, the U.S. economy has actually been in a slow recovery mode since the latter part of 2009 (see our Forecast table). Going forward, the economy is seen growing at 1.7 percent in 2013, 2.6 percent in 2014, 2.8 percent in 2015, and 2.7 percent in 2016. At the same time, inflation (as measured by the CPI) is expected to remain subdued, closing out the year at 1.4 percent and rising to only 2.2 percent by 2015.

In a recent survey of economists by the Federal Reserve Bank of Philadelphia, the economists see an 11.3 percent chance of negative growth in the current quarter, with the chance of negative growth in the following four quarters being in the 11.1 percent to 12.2 percent range.

We have determined a score of 61.92 percent from our Simple and Effective Economic Forecasting Model, which indicates a likely period of slow economic growth. This is the same score as we assigned in our March 2012 forecast, as the conditions indicating slow growth have not changed.

Please see the accompanying tables and graphs listed on the Economic Outlook page that detail our expectations and outlook for the economy.

THE STOCK MARKET

The watchword with regards to the U.S. stock market is **caution** – and use plenty of it!

In our view, the stock market is pretty fully valued, if not overvalued. On a trailing 12-month basis, the S&P 500 price-to-earnings ratio (P/E) is a little above 19. A general rule of thumb is that when the S&P 500 gets above 20, the market is starting to get overvalued. The 12-month forward P/E ratio is 15, which is above the 10-year average of 14; but below the 15-year average of 16.2 (Source of historical and current P/E averages: FactSet.com and other public sources reporting this data).

The favorable conditions supporting these fully-valued P/E ratios are a growing, albeit sluggish and uneven, economy and low interest rates, with the prospect of further accommodative Fed policy for the foreseeable future.

The conditions suggesting that caution is in order are persistently high unemployment; slowing corporate growth; and the likelihood that the Fed will start tapering off on QE. A change in the direction of the economy from its slow recovery and further slowing of corporate growth could spell disaster for stocks.

If making new stock purchases, go slow. Our suggestion is to spread purchases out over time to get into the stock market or to increase stock market exposure in an already established portfolio.

Works Cited

Aeppel, T. (2012, January 17). Man vs. machine, a jobless recovery. *The Wall Street Journal*.