Kicking the Can… Into February!

Why we don't like the market here

Brian Langenberg, CFA

Washington political dysfunction is not as bad as we feared. It is worse.

And while personal tax rates for most U.S. citizens are now a settled matter, there was no discernible change in the House or Senate. The President has nominated a tough political operator, Jack Lew, to head Treasury, and other picks, though not directly involved in economics, do not signal "new ideas" or change in direction.

Vice President Joe Biden—this is why you love your crazy uncle. He fumbles; he stumbles, and can run a 400-meter relay with a foot in his mouth because practice makes perfect. But at the end of the day, he is the dance partner from the administration. It is probable some "good cop/bad cop" was going on, but when all was said and done it was the VP who actually negotiated to get the last tax deal passed—even if it only kicked the can into February.

Brinkmanship (Cliff 2.0) will continue in the battle over spending. No matter what was agreed to in private, the Democrats are going to pitch the recent tax hikes in public as a down payment, while the Republicans will attempt to point out that taxes ("revenue" for some) have been addressed. Much ink will be spilt in the coming months with regard to the budget, mostly skewed against the Republicans.

Both sides have levers. The President has the bully pulpit and a Senate majority; the Republicans have Mitch McConnell who is a) tough, b) up for re-election in '14 and c) got the last deal done through Vice President Biden. Republican odds for success depend upon unity—and signals from House Majority Leader John Boehner that he will eschew further "talks" with the President in favor of working through the committees, and that he moves two smart, eloquent budget cutters—Eric Cantor (R-VA) and Paul Ryan (R-WI)—to the fore. Get your popcorn.

Long-term, three things matter: 1) Entitlement growth; 2) corporate tax reform; and 3) regulation. The near-term discussion will only be about entitlements and taxes on people. The administration wants wealth redistribution (no cuts anywhere, raise taxes), the Tea Party wants cuts everywhere, no taxes).

But don't expect any long-term fixes. While corporate tax reform has support on both sides of the aisle, every recent post-election political move we see does not signal bipartisanship or the possibility of a "grand bargain" that will help U.S. manufacturing by getting domestic corporate tax rates competitive with the rest of the world.

U.S. equities are likely (hopefully) to trade sideways. When it's all over, the range of likely outcomes around budget get us to "some entitlement cuts but not enough" and incremental "revenues" (taxes) elsewhere, thus reflecting the realities of a divided House, Senate and Administration. We have become very selective on names to own since December, reflecting higher stock prices (less potential return) and the likelihood of a noisy, dysfunctional battle on entitlements (higher risk) that will likely see Republicans using the debt ceiling as a cudgel against an Administration arguing for no restraints on growing entitlement spend.

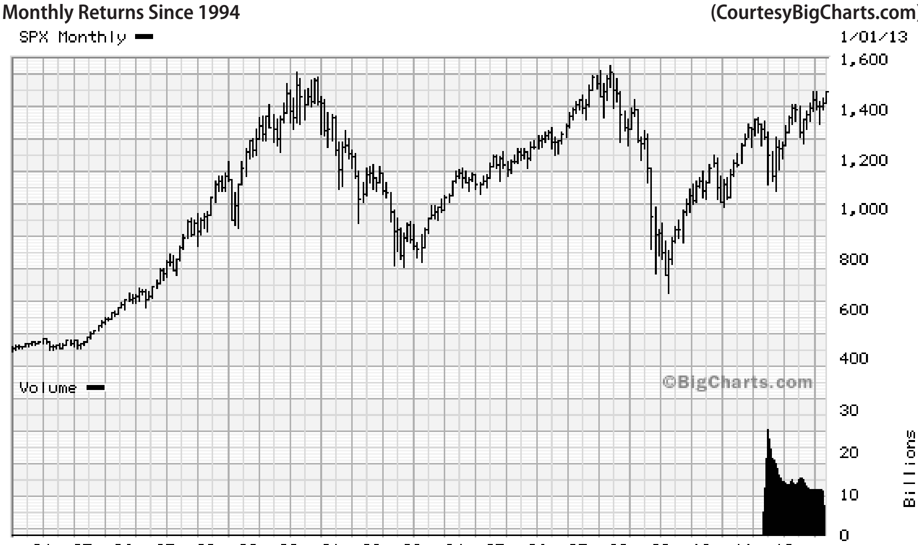
Market View: Cautious

The S&P 500 has risen six percent since our last article, discounting (temporary) resolution of fiscal cliff and an improving economy in China. Because of the changed relationship between risk (higher) and return (lower), we are very selective in our recommendations to institutional investors.

Generally speaking, market multiples are driven by interest rates (lower rate equals higher multiples) and risk premium (more volatility/fear drives lower multiples). The market trades at about 14× S&P 500 consensus 2013 estimates of $107, which has drifted

S&P 500
Monthly Returns Since 1994

(CourtesyBigCharts.com)



S&P 500:	1472.1			Pre-market 1/14/2013		
	S&P 500 Earnings			Implied Price Return		
P/E	$95	$105	$112	$95	$105	$110
13x	1,235	1,365	1,456	(16%)	(7%)	(1%)
14x	1,330	1,470	1,568	(10%)	(0%)	7%
15x	1,425	1,575	1,680	(3%)	7%	14%
16x	1,520	1,680	1,792	3%	14%	22%
17x	1,615	1,785	1,904	10%	21%	29%

down from $112 in November toward our $105 working assumption.

Using this relationship—broadly referred to in investing as the "Fed Earnings Model"—and dividing $107 by the S&P 500 Index ($107/1,471) translates into a seven percent "Earnings Yield," which compares to the 10-year Treasury at under two percent. However, we are living in "interesting times," with government, central bank and Treasury activity effectively supporting markets.

Assuming no expansion or contraction in the market multiple suggests a flat market at year-end. For what it is worth, most "large brokerage" strategists are calling for 1,400–1,600, with an average of 1,534.

Risk: More Downside than Upside

Our base case for the market is "about flat" at year-end with current levels. However, between there (December) and here (now), the only real potential upside driver would come from better than expected economic growth.

Pockets of strength will be found in the U.S. this year and China acceleration should drive better results for global operations and a number of European capital goods exporters. However, we believe those trends are largely built into industrial stock prices and the broader market.

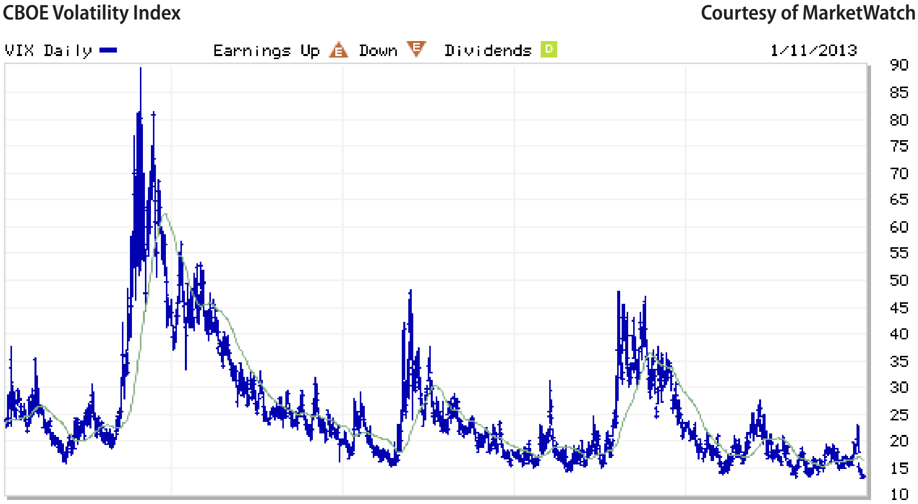
The ***CBOE Volatility Index***, which we show here, is a measure of expectation of risk in the stock market. The higher the index, the more implied risk.

Right now, the VIX is telling us there are no significant worries; the U.S. economy is gradually improving though underperforming its potential; and China is getting ready to accelerate. We think that is how things play out.

Which skews risk and return. The path to attractive returns is uphill in that an upward market move won't come from declining interest rates, which are already artificially depressed, or declining market volatil-

CBOE Volatility Index

Courtesy of MarketWatch



ity (already low). If the market is right, which we call a 75 percent probability, you can expect a 0-5 percent return in the market this year.

And the market may be wrong. We see a 25 percent probability of a protracted, drag-out fight that could lead to debt ceiling challenges and partial government shutdown, and plausibly impact the broader market. In this scenario, a successfully formed Republican United Front—Establishment + Tea Party—slugs it out with the administration, using its power over the purse strings, which can only be offset by the printing press at Treasury for just so long. Whatever the end result—and we have no reason to believe it will be a tea-and-crumpets discussion in DC, the media, or elsewhere—there is a pathway in the next several months to market softness and incremental negative economic impact.

Moving over to the actual industrial economy....

Market Return	% Prob.	
⇧	0.001%	Obama Steamrolled
⇧	0.01%	Grand Bargain
⇩	25%	Cage Match (Republicans go to the mat)
⇨	**74%**	**Muddle Some More**
⇨	1%	Republicans Steamrolled

SKY IS FALLING	S&P 500	Impl. Ret.
5/6/09 Armaggedon	683.38	(54)%
8/19/11 US Downgrade	1123.53	(24)%

China: Beginning to Accelerate

The ducks are getting lined up in a row. A new political leadership team is taking the reins and has to "prove itself" to everyone—the Party elders and broader population—and seek to boost its consumer economy while remaining competitive as an exporter. Which obviously means infrastructure development, social housing, healthcare investment and capital spending to substitute capital for labor.

Europe Will Benefit

We expect the European heavy capital equipment complex can start to benefit by the second half from both rising demand from China and easy comparisons, including motors, drives, bearings and industrial automation. While austerity, banking system issues and unemployment will likely dominate European "news flow" for awhile, we expect the *industrial* economy will strengthen on the back of capital investment driven exports.

What's Hot

We see a few opportunities for double-digit growth in 2013:

Global themes: Commercial aviation

U.S.: Automotive, residential construction, appliances, energy transmission, power distribution

China: Industrial automation, rail, social housing, auto; overhang in construction equipment likely to persist for at least another 2–3 quarters

Japan: Military spend.

Europe: Could see strong comparisons in late '13 (China).

For those whose responsibilities include business planning and having a broader, deeper grasp of major trends, we encourage you to consider subscribing to our Global Industrial Outlook (see page 49).

Top Picks

GE: You get the yield and the long-term value is there. Also, it has traded down nearly 10 percent from its high. My $2.50 earnings power view is intact—but there is a fly in my ointment about the power cycle. That is, energy efficiency gains on both the demand side (energy retrofit) and the supply side (utilities investing in transmission to forego further generation capacity additions); but directionally, we have earnings power, limited expectations, late cycle and yield.

UTX: Simple, easy path to value. Guide of $5.85–6.15 is conservative; I am at $6.20. Most of what we need to happen the company can control—executing the Goodrich integration, cleaning up CCS (Carrier HVAC + Fire & Security), and leverage to a China upturn (Otis). **PTE**

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Chinese exports grew 14% in December, including a 10.3% increase to the U.S.