Outlook 2013: The Economy and Equity Markets

With the election behind us and the makeup of power in Washington remaining largely unchanged, the question on the minds of many investors is: Where do we go from here? Despite the lingering uncertainties affecting the economy and investment markets, there are a number of reasons to be cautiously bullish on the coming year.

"With the yield on bonds near historical lows, and with the economy likely to pick up the pace rather than slip back into recession, we believe there is greater risk in owning bonds than dividend-paying stocks." -- Sam Stovall, chief equity strategist, S&P Capital IQ.

An Improving U.S. Economy

Standard & Poor's Economics expects annualized U.S. GDP growth of 2.1% this year and 2.3% in 2013, which is stronger than the 1.8% projected earlier, as recent jobs data offered more good news. S&P places the chance of another U.S. recession at about 15% to 20%, equal to the likelihood of a quick turnaround.

Key 2013 Targets

12-Month S&P 500: **1550**

S&P 500 EPS 2012E: **$102.73**; 2013E: **$112.57**

Fed Funds Rate 2013 Avg.: **0.2%**

10-Year Note Yield 2013 Avg.: **2.1%**

Real GDP Growth: 2012: **2.1%**; 2013: **+2.3%**

Elsewhere in the economy, recent reports pointed to a continued recovery in the housing market. The S&P/Case-Shiller 20-City Home Price Index was up 3.0% from a year earlier in September, better than the 2.5% gain that was anticipated. This was the fourth consecutive year-over-year increase in prices and came after three years of decline. S&P expects that home prices have finally stabilized, and are likely to climb in the coming year.

Indecision in the political arena -- most notably ongoing contention over how to handle the so-called fiscal cliff -- is still the U.S. recovery's biggest threat. However, as stated by Beth-Ann Bovino, Standard & Poor's Economics' deputy chief economist, "The fiscal cliff cuts both ways: While it could send the economy back into recession next year, a final credible resolution coming sooner than markets think could also give our economy the greatest chance of taking off."

Global GDP Growth

The outlook for global economic growth is one of cautious optimism, with growth forecast to reach 3% by Q4 2013, up from only 2.2% in Q1. S&P believes this outlook reflects three significant macroeconomic overhangs: the U.S. fiscal cliff, Europe's recession and debt crisis, and the still unknown trajectory of China's growth.

According to Alec Young, S&P Capital IQ's global equity strategist, "As China is the world's fastest-growing major economy, its ability to maintain strong growth is key to the global outlook, especially given Europe's recession, anemic growth in Japan, and the risk of fiscal drag in the United States. Recent news has been encouraging with industrial production, retail sales, and exports all rebounding from their summer troughs. In addition, Chinese manufacturing moved back into expansionary territory in October." The consensus sees China's 2013 growth remaining solidly in "soft landing" territory, at 8.1%, up from the 7.7% seen for all of 2012.

The S&P 500's price advance since early June may reflect investors' encouragement that a trough in global GDP growth is on the horizon. According to S&P and I.H.S. Global Insights' projections of year-over-year growth in global regional GDP, the trough in growth in all regions will largely be behind us as the new year dawns.

International Stocks

While 2013 earnings per share (EPS) expectations for the MSCI EAFE and MSCI EM indexes remain healthy at 12.8% and 13.1%, respectively, S&P's Young sees these forecasts being revised lower in the coming months due to the above-mentioned macroeconomic uncertainties. Nevertheless, S&P's base case calls for EPS growth to continue in 2013, with mid-single-digit percentage gains likely.

With modest price appreciation forecast for international stocks in 2013, Young recommends a focus on equity income as a means of supplementing total returns. "Since the start of 2010, dividends have comprised 100% of both developed international and emerging market equity total returns. This trend has been playing out in 2012 as the MSCI EAFE Index's 7.7% total return is roughly double its 3.9% price gain. Similarly, emerging market equities are up 8.9% on a total return basis versus only 5.8% on a price basis. When price gains are modest, dividends are hugely important to maintaining equity performance that's in line with historical averages."

Domestic Stocks

S&P Capital IQ's Investment Policy Committee has raised its 12-month S&P 500 target to 1550 from 1500, implying a 10% advance from the November 28, 2012, close. Commenting on the outlook for domestic stocks, Mark Arbeter, S&P Capital IQ's chief technical strategist observed, "While many have thrown in the towel on equities and embraced Treasury bonds, which yield a whopping 1.6%, the S&P

MidCap 400 and the S&P SmallCap 600 hit all-time highs this year. In addition, a measured move based on the S&P 500's [current] bullish pattern could take the index up to, and possibly higher than, the highs in 2000 and 2007."

Focus on Dividends -- Whatever the conclusion of the fiscal cliff standoff, S&P believes that higher taxes on dividends will likely be included. Yet, that doesn't mean that investors should avoid dividend-paying stocks. First, it is becoming increasingly difficult to find stocks without a yield, as 80% of the S&P 500 now pay a dividend. Second, S&P strategists believe that the tax on dividends, at worst, will be equal to that on bonds. Finally, with the yield on bonds near historical lows, and with the economy likely to pick up the pace rather than slip back into recession, S&P believes there is greater risk in owning bonds than dividend-paying stocks.

Sector Plays -- S&P Capital IQ's Equity Strategy group is currently recommending a hedged approach to sectors as it attempts to anticipate the unraveling of uncertainty. That said, based on relative fundamental and technical considerations, S&P currently has overweight recommendations on the Consumer Discretionary and Health Care sectors, underweights on Materials and Utilities, and neutral weightings on Consumer Staples, Energy, Financials, Industrials, Information Technology, and Telecom Services.

Recommended Asset Allocation

S&P Capital IQ's Investment Policy Committee maintains its neutral recommended exposure to global equities at 45% domestic and 15% international. It also recommends a neutral 40% overall weighting to fixed income, with a 25% exposure to bonds (versus its normal 30% weighting) and a 15% holding in cash (versus its normal 10%).

Source: S&P Capital IQ, Global Equity Research, "The 2013 Equity Outlook," November 26, 2012.

Source: S&P Capital IQ, Global Equity Research, International Investment Outlook, "2013 Outlook: Visibility Vacuum," November 26, 2012.

Source: S&P Capital IQ, U.S. Investment Policy Committee Notes, November 28, 2012.