



Weekly Market Commentary



December 17, 2012

Apocalypse Now?

Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

The end of the world is purported to take place this Friday, December 21, 2012. Like a primeval Y2K event, the Mayans believed that as the cycles aligned, the world as we know it will come to an end and will experience a profound transformation.

Many investors have been focused on this same date as a doomsday for another reason; it is the day Congress is scheduled to adjourn for the year, risking a leap off the fiscal cliff.

We believe the cycles that are aligning will lead to a transformation in the fiscal, economic, and political environment with profound impacts for investors.

Given all the news coverage and the drama over what is at stake, it can be easy to think of going over the fiscal cliff—as the spending cuts take effect and tax cuts finally expire—as the end of the world. Wary of the consequences of this collision course with destiny, investors have shunned stocks by selling their holdings of U.S. stock mutual funds on a net basis in every single month this year and stepping it up lately to total over \$20 billion in net selling during just the past four weeks, according to Investment Company Institute data. Yet, despite the fear and selling, the S&P 500 has posted gains over the past four weeks, and this year turned out as we had forecast a year ago in our *2012 Outlook** with a better-than-average gain for the stock market.

Many investors have been focused less on December 31 as the date the fiscal cliff countdown clock is ticking down to, but instead on this Friday December 21—the day Congress has targeted to adjourn—as a more important upcoming date (see [Figure 1](#) for more).

1 Upcoming Key Dates Related to the Fiscal Cliff

Dec. 18, 2012	May be the last date for any bill to be introduced to Congress. If Congress follows its rules (in the House of Representatives, lawmakers must have at least three days to review a major piece of legislation before being asked to vote on it), this may be the last day to introduce a bill.
Dec. 20, 2012	President Obama and his family may leave Washington, D.C. for their annual family vacation in Hawaii.
Dec. 21, 2012	Congress is currently targeted to adjourn for a full holiday break
Late Dec. 2012	The Treasury will have to direct companies to prepare new withholding schedules that can be effective and implemented on January 1 as taxes increase. Failure to prepare and distribute new schedules may be a hint that the Treasury believes a deal is imminent.
Jan. 1, 2013	New tax rates and rules take effect.
Jan. 2, 2013	Spending cuts due to begin from 2011 Budget Control Act
Late Feb. to Early Mar.	Federal government due to hit \$16.394 trillion debt ceiling. The federal government is scheduled to hit the borrowing limit within weeks, but policymakers can use emergency measures to buy more time until February or March. The debate over the debt ceiling—last seen in August 2011—could become another cliff if the House just passes a bill similar to the Senate bill this summer that addressed only some of the current issues of contention—including the debt ceiling.
Mar. 27, 2013	Funding of federal government expires. If no deal is reached to fund it beyond that date, there could be a partial government shutdown.

* LPL Financial provided this range based on our earnings per share growth estimate for 2012, and a modest expansion in the price-to-earnings ratio.

Source: LPL Financial 12/17/12



The End of the World

December 21 also happens to be the day that another doomsday clock is ticking down to. The Mayans, who spread across Central America from about 2000 B.C. to 900 A.D., used a unique Mesoamerican “long count” calendar that marked time in long cycles lasting 394.3 years called b’ak’tun. A “sun,” or era, may be defined as 13 b’ak’tun cycles. The Mayan creation date was in 3114 B.C., and the 13th b’ak’tun cycle will end on Friday of this week—on December 21, 2012.

The Mayan calendar has three “calendar rounds;” these three cycles each turn as time passes. They align with each other in a unique way to begin a new full cycle only rarely, and like a primeval Y2K event, the Mayans believed that the world as we know it will come to an end and will experience a profound transformation.

The Mayans may be right about three cycles coming together and transforming into a new era. But we don’t think it takes any mystical knowledge to see the new era transforming in the fiscal, economic, and political cycles that has profound impacts for investors.

Fiscal Policy Cycle

The fiscal policy cycle is turning to a new phase, away from the tremendous stimulus and spending of the past five years to austerity and cuts. The decision on the fiscal cliff will set in motion the path for addressing the country’s long-term fiscal solvency. The structure and depth of this new multiyear phase of fiscal policy will soon be decided. This change in fiscal policy after years of helping to boost the stock market may act as a drag on the economy and markets in 2013.

Alternatively, a long-term solution would be bullish for equities and the economy because it would take a substantial first step toward fiscal sustainability. It would greatly reduce the risk of a crisis at some point, which is almost inevitable given how quickly the United States is accumulating debt annually. It would provide long-term clarity on taxes, spending, and eliminate annual debt ceiling fights or fiscal cliffs for at least the next few years. To the extent that these risks and uncertainties are causing businesses and consumers to stay on the sidelines, these headwinds to economic growth would be lifted—more than offsetting any fiscal drag.

Economic Cycle

It is now three-and-a-half years since the economic cycle turned from recession to growth. The economic cycle may be set to turn once again. Going over the fiscal cliff would likely result in a turn in the economic cycle back to recession and a bear market for investors, although not a deep one. There are positives to fiscal austerity and the lack of asset bubbles (such as those seen in the technology or housing markets) built up over just three-and-a-half years of modest economic growth. Rising taxes hurt consumer spending, hiring decisions by businesses, and business capital



spending, while the spending cuts would crimp government outlays, and in some cases, business capital spending. The cuts to Medicare payments to doctors and the end of extended unemployment benefits would directly impact personal incomes and personal spending. A bear market for stocks may ensue as earnings begin to fall. Inflation would remain muted, and the unemployment rate would push closer to 9% from around 8% in late 2012, prompting the Federal Reserve (Fed) to provide more stimulus. These actions, along with the rising unemployment rate and slightly lower budget deficit, could apply further downward pressure to interest rates, benefiting the bond market.

Alternatively, the potential for a grand bargain that leads to the removal of uncertainty surrounding the nation's long-term deficit issues, accompanied by long-term visibility in the tax code, may provide a significant boost to the consumer and business confidence, and may lead to higher economic growth, better job growth, less accommodation from the Fed, and perhaps higher inflation, and a bull market for stocks.

Election Cycle

The election cycle has started anew. The political compromise—or lack thereof—sets the tone in Washington for the next two years, if not longer. While the divisiveness in Washington seems to have hit new highs, it could always get worse. The moderates in both parties, such as the fiscally conservative Democrats in the southeastern states and some New England Republicans, have been largely replaced by more partisan peers. The rancor can act as an impediment to lifting stock market price-to-earnings ratios from near 20-year lows. On the other hand, maybe we have reached the limits of partisanship. It is possible we are about to see the pendulum of partisanship swing from near total divisiveness toward more harmony among the parties in the coming years. It has happened before; it could happen again. Markets would likely welcome the change.

A New Era

Post-apocalyptic works of fiction show the future to be fraught with danger, but they also often feature flying cars—so it may not be all bad. As we look to 2013, we do not see an end-of-the-world scenario for investors. The base case path we expect in 2013 is likely to bring modest single-digit returns for investors, perhaps surprising those that see no avoiding a self-imposed apocalypse and continue to sell.

We expect Congress will continue to work toward a deal, even as some of the key dates featured in [Figure 1](#) pass. Here is hoping that as the cycles turn a transformational new era emerges where politicians, business leaders, and individuals' interests align to produce an environment of respect and much-needed action. ■



IMPORTANT DISCLOSURES

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Stock investing involves risk, including the risk of loss.

INDEX DEFINITIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

This research material has been prepared by LPL Financial.

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Weekly Economic Commentary



December 17, 2012

This Is Mandatory Reading

John Canally, CFA

Economist
LPL Financial

Highlights

This week's commentary continues our series on the long-term U.S. budget problems and possible solutions.

Mandatory spending on programs like Social Security, Medicare, and Medicaid are very popular and well entrenched in the American system, but they need to be addressed to fix the long-term budget problem.

As in other large areas of the U.S. budget, there are no easy fixes, and hard choices will have to be made.

Please see the LPL Financial Research Weekly Calendar on page 3

As Congress and the President work together to avoid the looming fiscal cliff during the lame duck session of Congress, a more intransigent problem remains in the background: the United States' structural budget deficit. In our *Weekly Economic Commentaries* of October 29, 2012 (*Budget Debate*), November 19, 2012 (*Budget Myths*), and November 26, 2012 (*Budget Defense*), we wrote about how often the budget was mentioned during the campaign season and how the nation's long-term budget problem cannot be solved by eliminating waste, fraud, and abuse, domestic discretionary programs, and foreign aid alone. In addition, we put the nation's defense spending in context of the larger budget picture. In our view—a view shared by most nonpartisan budget experts—all aspects of the budget must be on the table during the fiscal cliff deliberations, and again in 2013 as lawmakers hammer out a longer term fix to our budget mess that has led to the overspending of revenues by about \$1 trillion per year over each of the past five years.

Setting the Stage

In late 2010, three different nonpartisan organizations released plans that would put the United States on a path toward a balanced budget, using a combination of revenue/tax increases and spending cuts to achieve that goal. These organizations are:

- The President's National Commission on Fiscal Responsibility and Reform (commonly known as Bowles-Simpson);
- Bipartisan Policy Center (commonly known as Rivlin-Domenici); and
- Pew-Peterson Commission on Budget Reform.

While each plan differed on certain aspects of the longer term fix for our budget woes, they all generally agreed that there are no easy answers and no quick fixes. Both Democrats and Republicans populated the three commissions. Some hold (or once held) elected office, while others served in the federal government or were on the boards of the many think tanks in and around Washington. All were focused on finding bipartisan solutions to the problem.

In early November 2012, the nonpartisan Congressional Budget Office (CBO) released a report called "Choice for Deficit Reduction," which "reviews the magnitude and causes of the federal government's budgetary imbalance,

1 Subsets of Mandatory Spending in Fiscal Year 2012

Mandatory Spending Fiscal Year 2012



Source: CBO, LPL Financial Research 12/17/12



If you have not done so, we urge you to go to the websites of the nonpartisan organizations referenced on page 1, as well as to the CBO site, and review their budget plans. While the policy prescriptions in any of these plans are unlikely to be adopted “as is” and passed into law, the budget concepts discussed in these reports are likely to form the basis of any long-term fix to our budget problems.

various options for bringing spending and taxes into closer alignment, and criteria that lawmakers and the public might use to evaluate different approaches to deficit reduction.”

In general, the three commissions (and the CBO) concluded that in order to successfully tackle the longer term deficit problem, formerly politically untouchable areas must be on the table in any serious negotiation. These areas include:

- Social Security;
- Defense spending;
- Farm subsidies;
- Medicare;
- Medicaid;
- Personal and corporate tax rates; and
- Tax expenditures, more commonly known as personal and corporate tax deductions (e.g., home mortgage interest, state and local real estate tax, or charitable contributions).

The plans put forth by the three deficit commissions did vary on the amount of revenue increases (via some combination of higher tax rates, higher premiums for Medicare, fewer deductions, and more income subject to taxation, etc.) relative to spending cuts (across all categories of federal spending) needed to achieve a long-term path toward fiscal stability.

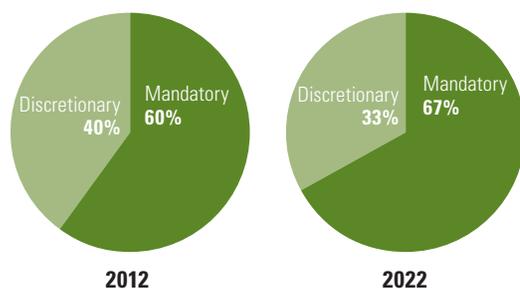
Slicing and Dicing: Mandatory Spending Is the Largest Slice of the Pie

As we noted in prior budget-related commentaries, the federal budget can be sliced and diced several ways. One way to look at the budget is by function or cabinet post, such as the Department of Labor, Department of the Interior, Department of Defense, etc. Another way is to group the spending categories together by legislative mandate—mandatory spending and non-mandatory spending (also known as discretionary spending). Mandatory spending is all spending that is not controlled through Congress’ annual appropriation process. For the most part, mandatory spending is based on eligibility criteria and benefit of payment rules set into law. Examples include Social Security, Medicare, Medicaid, the Affordable Care Act (aka “Obamacare”), and interest on the public debt.

In recent fiscal years, mandatory spending has accounted for the majority of all federal spending, and this slice of the pie is set to rise dramatically in the coming decade. Therefore, curbing mandatory spending, or changing the way mandatory spending is funded, holds the key to addressing our long-term budget issues. This week, we will take an in-depth look at mandatory spending, and explore some of the options available to policymakers to address these programs over the long term.

2 Mandatory Spending Expected to Reach 2/3 of All Federal Spending by 2022

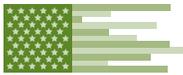
Percent of U.S. Federal Budget Outlays



Source: CBO 12/17/12



LPL Financial Research Weekly Calendar

	U.S. Data 	Fed 	Global Notables 
2012			
17 Dec	<ul style="list-style-type: none"> Empire State Manufacturing Index (Dec) 	<ul style="list-style-type: none">  Lacker 	<ul style="list-style-type: none"> Eurozone: Trade Balance (Oct)
18 Dec	<ul style="list-style-type: none"> Current Account Balance (Q3) 	<ul style="list-style-type: none">  Fisher 	<ul style="list-style-type: none"> India: Central Bank Meeting China: Property Price data (Nov) Japan: Trade data (Nov) Sweden: Central Bank Meeting
19 Dec	<ul style="list-style-type: none"> Housing Starts (Nov) 		<ul style="list-style-type: none"> China: Leading Indicators (Nov) Germany: IFO (Dec) Taiwan: Central Bank Meeting Norway: Central Bank Meeting South Korea: Presidential Election
20 Dec	<ul style="list-style-type: none"> Initial Claims (12/15) Philadelphia Fed Index (Dec) Existing Home Sales (Nov) Leading Indicators (Nov) GDP (Q3) 		<ul style="list-style-type: none"> Japan: Central Bank Meeting UK: Retail Sales (Nov) Eurozone: Consumer Confidence (Dec)
21 Dec	<ul style="list-style-type: none"> Personal Income and Spending (Nov) PCE Deflator (Nov) Durable Goods Orders (Nov) University of Michigan Consumer Sentiment and Inflation Expectations (Dec) 		
24 Dec			
25 Dec	<ul style="list-style-type: none"> Holiday 		
26 Dec	<ul style="list-style-type: none"> Case-Shiller Home Price Index (Oct) Richmond Fed Index (Dec) 		
27 Dec	<ul style="list-style-type: none"> Initial Claims (12/22) Consumer Confidence (Dec) New Home Sales (Nov) 		<ul style="list-style-type: none"> Japan: Industrial Production (Nov) Japan: CPI (Dec) Japan: Retail Trade (Nov)
28 Dec	<ul style="list-style-type: none"> Chicago Area Purchasing Managers Index (Dec) Pending Home Sales (Nov) 		

 Hawks: Fed officials who favor the low inflation side of the Fed's dual mandate of low inflation and full employment

 Doves: Fed officials who favor the full employment side of the Fed's dual mandate

* Voting members of the Federal Open Market Committee (FOMC)

In fiscal year 2012 (which ended on September, 30, 2012), mandatory spending (Social Security, Medicare, Medicaid, etc.) totaled more than \$2 trillion, or about 60% of total federal outlays. According to projections made in August 2012 by the nonpartisan CBO, mandatory spending will reach \$3.9 trillion and will account for more than two-thirds of federal spending. The CBO projects that spending for Social Security benefits will increase by 75% over the next 10 years, and that Medicare spending will basically double over that same time. Medicaid costs are expected to more than double. By comparison, the CBO projects that GDP will increase by only 60% over the next 10 years and that federal tax revenue will increase by 117%.



Medicare:

Medicare provides subsidized medical insurance for the elderly and for some disabled people. Spending for Medicare totaled about \$555 billion in 2012, providing coverage for about 50 million people. The CBO projects that Medicare spending will continue to rise rapidly over the next decade, as baby boomers retire and spending per beneficiary continues to rise.

Medicaid:

Medicaid provides medical care for certain poor and low-income people. Children's Health Insurance Program (CHIP) provides coverage for children in low-income families that do not qualify for Medicaid. Federal spending for Medicaid and CHIP was about \$251 billion and \$9 billion, respectively, in 2012, and over 58 million American receive Medicaid benefits. The CBO projects that federal Medicaid spending will rise rapidly over the coming decades because of expanding eligibility under the Affordable Care Act, the aging of the population, and rising costs per beneficiary.

Social Security:

Social Security, the federal government's largest single program, provides benefits to retired workers (through Old-Age and Survivors Insurance, OASI), to people with disabilities (through Disability Insurance, DI) and to their families as well as to some survivors of deceased workers. In all, more than 56 million Americans currently receive some type of Social Security benefit. Those benefits are financed primarily by payroll taxes collected on people's earnings. The CBO anticipates that starting in 2016, if current laws remain in place, the program's annual spending will regularly exceed its tax revenues, and by 2038, the Social Security trust fund will be exhausted (i.e., out of money).

The major drivers of the rising costs are the aging population and rising per-patient medical costs. In a recent report, the CBO notes:

“The increase in spending for health care programs is much greater than the increase for Social Security because the health care programs are affected by rising costs per beneficiary and legislated expansions in benefits, as well as by the aging of the population.”

The CBO notes that these three programs (Social Security, Medicare, and Medicaid) today account for 10% of gross domestic product (GDP). Under current law, these three programs alone will account for 16% of GDP by the mid-2020s. By comparison, the CBO noted, all federal spending (excluding interest payments but including these three programs) has averaged around 18% of GDP since 1970.

As we have noted in prior *Weekly Economic Commentaries*, policymakers face very difficult choices in dealing with the deficit in other areas of the budget (defense, non-defense discretionary, etc.). The choices faced in dealing with the runaway pace of mandatory spending are even more difficult, given that programs like Social Security and Medicare are both well entrenched and among the most popular federal government programs. Still, the commissions, think tanks, and the CBO have cited several options to rein in mandatory spending.

The options for Social Security fall into five categories, as defined by the latest CBO report:

- Increases in the Social Security payroll tax;
- Changes in the way benefits are calculated;
- Increases in benefits for low earners;
- Increases in the full retirement age; and
- Reductions in the cost-of-living adjustments that are applied to continuing benefits.

For example, combining the concepts underlying the bullets above, the CBO notes that if the Social Security payroll tax rate was increased immediately and permanently by 1.95 percentage points—from the current rate of 12.40% to 14.35%—or if scheduled benefits were reduced by an equivalent amount, then the trust funds' projected balance at the end of 2086 would equal projected outlays for 2087. As noted in the nearby box, under current policies, the trust funds would be exhausted by 2038.

Short of eliminating the programs altogether, the policy options to slow the pace of spending on Medicare and Medicaid are similar to the options for Social Security and include concepts like:

- Raising the eligibility age for Medicare;
- Raising payroll taxes that go toward funding Medicare;
- Cutting the rate of growth of payments to providers of Medicare services;
- Repealing some of the components of the Affordable Care Act;



- Raising Medicare premiums;
- Reforming Medicare cost-sharing rules; and
- Reducing Medicare and Medicaid fraud.

While none of these options by themselves completely solves the problem of medical costs rising faster than the growth rate of GDP, some do make a sizable dent in the deficit. For example, the Bowles-Simpson budget commission noted that by combining several of the changes noted above, Medicare spending could be reduced by \$110 billion over the next 10 years.

But this policy option would likely come at a cost to both users of Medicare: seniors and doctors. Seniors would face sharply higher out-of-pocket health care costs, which has implications for many other parts of the economy. For example, seniors would likely cut back on other areas (housing, leisure activities, etc.) to fund their health care spending. Lower payments to providers of Medicare services (doctors) would see their income fall (or rise at a slower) rate, leading some doctors to leave the medical field, and others to cut back on their own spending, both business and personal.

The bottom line is that much work remains to be done in order to address the real driver of the nation's long-term budget woes: mandatory spending, including Social Security, Medicare, and Medicaid. As with the other possible budget remedies, there are no easy choices in dealing with mandatory spending, but the longer we wait to address them, the more difficult it becomes to address them later on. ■

LPL Financial Research 2012 Forecasts

GDP 2%*

Federal Funds Rate 0%[^]

Private Payrolls +200K/mo.t

Please see our *2012 Outlook* for more details on LPL Financial Research forecasts.



IMPORTANT DISCLOSURES

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* Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

^ Federal Funds Rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve, called federal funds, with each other, usually overnight, on an uncollateralized basis.

† Private Sector – the total nonfarm payroll accounts for approximately 80% of the workers who produce the entire gross domestic product of the United States. The nonfarm payroll statistic is reported monthly, on the first Friday of the month, and is used to assist government policy makers and economists determine the current state of the economy and predict future levels of economic activity. It doesn't include:

- general government employees
- private household employees
- employees of nonprofit organizations that provide assistance to individuals
- farm employees

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

The index of leading economic indicators (LEI) is an economic variable, such as private-sector wages, that tends to show the direction of future economic activity.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

INDEX DESCRIPTIONS

China CPI: In total there are about 600 "national items" used for calculating the all-China CPI. The list of items is revised annually for representativeness based on purchases reported in the household surveys. The number of items can change from year to year, but rarely by more than 10 in any given year.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The Michigan Consumer Sentiment Index (MCSI) is a survey of consumer confidence conducted by the University of Michigan. The Michigan Consumer Sentiment Index (MCSI) uses telephone surveys to gather information on consumer expectations regarding the overall economy.

The S&P/Case-Shiller U.S. National Home Price Index measures the change in value of the U.S. residential housing market. The S&P/Case-Shiller U.S. National Home Price Index tracks the growth in value of real estate by following the purchase price and resale value of homes that have undergone a minimum of two arm's-length transactions. The index is named for its creators, Karl Case and Robert Shiller.

The Empire State Manufacturing Index is a seasonally-adjusted index that tracks the results of the Empire State Manufacturing Survey. The survey is distributed to roughly 175 manufacturing executives and asks questions intended to gauge both the current sentiment of the executives and their six-month outlook on the sector.

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