Comments on the Fiscal Cliff

Why is the market happy?

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The grand bargain was a bust, earnings expectations are falling, Europe is still in recession, etc. Yes, the bulk of the tax cliff was avoided. But there is still some brutal negotiations to come over further deficit reduction. Both Republicans and Democrats hate the deal reached. Market strategists warn of the potential turmoil of the debt ceiling and sequester negotiations. So why is the market rallying to new post recession highs? Like most in the profession, we have had to dig below the surface to glean the reasons.

Starting with the economy. One of the reasons the market has not shuddered with fear with Armageddon so close to becoming reality is that economic data did not succumb to dire predictions. In fact, U.S. economic announcements in the last few months were on balance positive surprises. Signs of business spending slowing were not as dramatic as expected and were offset by a pick-up in consumer demand for credit and spending. House prices and activity is picking up, while except for a storm induced blip jobless claims have continued to abate signaling a better job market may be imminent. In aggregate, the economy did not support the fiscal cliff induced slowdown storyline.

Against that economic backdrop market action continued a theme we have cited several times during the year. We have contended that with both the economy and earnings hitting all time highs, and the market lagging, that earnings power already achieved justified higher stock prices. But fear of the fiscal cliff, the break-up of the Euro, and possibility of a hard landing in China have kept stock prices from fully reflecting that earning potential. In the final quarter of 2012 investors further embraced the idea that the ECB would "do whatever it takes" to save the Eurozone as CDS prices continued to fall. A leadership change in China removed uncertainty and many Chinese business indicators showed signs of some reacceleration. Most importantly, investor, business, and consumer confidence that Washington would not let us go over the fiscal cliff grew stronger as the clock ticked closer to the deadline. While we find this ironic given the risk avoidance mantra of the past few years the lack of fear was a significant driver of stock prices and is apt to continue to be a key ingredient in market valuations.

Looking forward, one could contend that the deal did not solve the fiscal problems of the U.S. budget and there is still so much work to be done. Shouldn't that give investors pause with stock prices at post recession highs? A very legitimate question in our view. But the equilibrium between stock prices and earnings potential already achieved has not been reached yet. What that means is that the market can rise if fear recedes further. Yes, the fiscal deficit work is not done, but the worst case scenario has been taken off the table. While there is still a deep split in Washington, the economic story is one of pent-up demand. In the near term the economy looks poised to continue to grow slowly, which is likely to result in single digit earnings growth. Like our peers, we worry about politicians, but find them next to impossible to analyze or predict. They have the potential to derail the promise of the economy and market, but that is a worry that we will have to live with for many years to come. So we are trying to stay focused on the numbers, which are constructive for the market in 2013.