MV Capital Management Thought Leadership

2012 Year in Review: The Year of Living on the Edge

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On the surface it seems we should have little to complain about and lots of good cheer to take us through the holiday season and into the New Year. U.S. equity markets have been in double digit positive territory for most of the second half of the year. Broad market averages are up more than 15% year-to-date with just one more full calendar day of trading left before ringing out the old year, and that has been accomplished with significantly less volatility than was the case in 2011. Yet there seems to be an asterisk next to the better-than-average performance, a sort of "yes, but…" caveat to the numbers. That is in no small part due to the fact that in the year gone by markets have flirted with, and then somehow managed to either avoid or postpone, a series of global economic crises. And as we write these words there is one more high-wire act the markets are trying to put behind them. That, of course, is the so-called "fiscal cliff" that has become so ingrained into the mainstream conversation that it gets mention not just during the daily business roundup on the nightly news but also in the local weather report. There are "fiscal countdown calendars" in so many places that the whole Mayan calendar would-be apocalypse last week was an even bigger non-event than it was going to be anyway. With all the focus and concern on this topic we want to take this opportunity to do two things: first, to consider the fiscal cliff in the context of other would-be meltdowns we have thus far avoided; and second to share our views about how it may be unfolding as we head into the New Year.

Eurocrash Averted

"Never do today what you can put off for tomorrow": the time-tested slogan of procrastinators has taken hold of the mindset of policymakers around the world. As the year opened we were on the brink of a complete meltdown in Europe. Such sober-minded publications as the *Economist* were openly contemplating in their pages the unraveling of the single currency Eurozone. But the great and the good put their collective heads together and banged out a temporary solution in the form of extending the term on obligations coming due for European financial institutions – basically ensuring that we would not be treated to the specter of systemic defaults any time soon. Later in the year when Eurozone concerns flared up again European Central Bank chief Mario Draghi tough-talked markets into submission by bring a reluctant Germany on board to giving the ECB authority to manage a sovereign crisis in Greece or Spain or wherever with Eurobond issuance.

QE4-Ever

Not to be outdone by his European colleagues U.S. Fed chief Bernanke spiked the punch bowl again in September with a new round of quantitative easing, pledging to inject $40 billion into fixed income markets each month until "things are better" – giving the Fed a rather wide latitude to decide when and what "better" actually means. This series of events – from Draghi's words in July through the QE III announcement in September – put a solid floor under the market. At the same time there were growing signs of an improving economic landscape in the U.S., with unemployment ticking below 8% in October, housing data showing their best results in years, and consumer confidence also reaching levels not seen since before the 2008 recession. The U.S. elections came and went without endless recounts muddying the waters. Now we knew who would be sitting at the negotiating tables and figuring out how to steer us through the next obstacle in our Fun House of policy crises – and that obstacle now took front and center stage – the fiscal cliff.

Cliff Diving

The interesting thing about the fiscal cliff from the immediate post-election period to a few days ago is how markets have greeted it with a collective yawn. Stocks have had their up days and down days, but nothing like the intensive price gyrations that accompanied the debt ceiling discussions in the summer of 2011. Even in the last several trading days, when the likelihood of actually reaching the cliff without a deal in hand by the end of the year has increased, the market's reaction has been comparatively sanguine. Do the traders who trade in and out of the market every day know something that the rest of us don't, or are they flying blind into a nasty New Year surprise?

It is too early to say that we are out of the woods, but the fact is that January 1 is not the drop-dead date after which everything falls apart. Neither is January 3 – except perhaps for John Boehner, who will learn then whether he is destined to be reinstated as House Speaker or whether another Republican will be leading the floor thenceforth. The question is whether the parties can all come together over the first several weeks of January and come up with something – most likely another round of the "kick the can" – to avert the full blow of tax increases and spending cuts that will otherwise take effect. If they do – and recent history tells us that this is certainly a distinct possibility – then we think there is a good case to make that market sentiment could turn positive as the threat of a return to recession fades from being a clear and present danger. But there is also a good chance that the first few days of the year could be a bumpy ride before the fog clears on how far each side is willing to go.

Scenarios and Outcomes

The future is unpredictable, and what happened in the past does not guarantee what will happen next time around. Our tools of the trade in managing portfolio exposure in different market environments include scenario testing to establish potential alternative outcomes, and lots and lots of data analysis to support our hypotheses and conclusions. Rest assured we are deep into the numbers on a daily basis and will not be taking our eyes far from the market during the rest of the holiday season and beyond. We have our own views on best, worst and most likely case scenarios for how the fiscal cliff plays out and what the growth environment for 2013 looks like. But we are not dogmatic – we let the data inform us and adjust our expectations accordingly.

We wish all of our clients and friends a happy holiday season and a healthy and prosperous 2013.

With best regards,

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