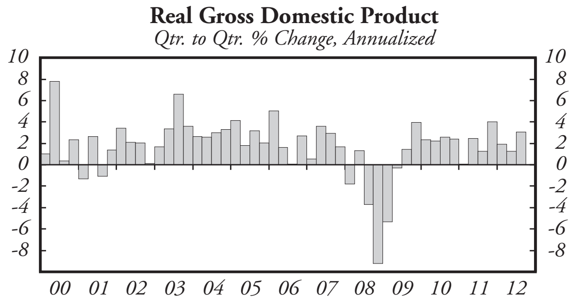
WHV Investment Management

REVIEW AND OUTLOOK - WINTER 2013

Economic growth remains tepid.



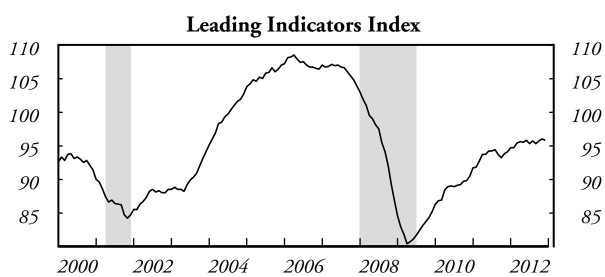
Real Gross Domestic Product (GDP), the total output of goods and services within the United States adjusted for inflation, expanded at an annual rate of 3.1 percent in the third quarter compared to 1.3 percent in the second quarter. The third quarter was aided by one-time contributions from a jump in defense spending and inventory accumulations, the latter being an indication of weak final demand. Adjusting for these probably non-recurring events, GDP grew at a tepid pace of 1.7 percent. Estimates for the fourth quarter growth in GDP fall between 1 and 2 percent.

Permanency of tax code removes some uncertainty.

The economic recovery that began in June 2009 has lasted for 42 months through December and has averaged a growth rate of 2.2 percent. A partial resolution to the "fiscal cliff," tax increases and spending cuts that were to take effect January 1, 2013 amounting to 4 percent of GDP, removes some of the uncertainty that has plagued the economy over the past decade. The changes in the tax code passed by Congress and signed by the President have no "sunset "provision and are therefore permanent. The top marginal income tax rate will rise to 39.6 percent for individuals with incomes above $400,000 and couples with income above $450,000. The payroll tax for employees will rise to 6.2 percent from 4.2 percent. The dividend and capital gains tax will rise to 20 percent from 15 percent. This form of income as well as other non-wage income will be subject to an additional 3.8 percent tax under the Affordable Care Act. Both consumer and business confidence should have improved due to the permanent nature of the tax code revisions. This in turn should have encouraged corporate spending on equipment and software, a component of GDP that was down in the second half of 2012. However, the legislation failed to address an increase in the federal debt ceiling and postponed for two months the mandatory spending cuts. This will lead to another "budget battle cliff" by March, and given the dysfunctional behavior of our elected officials, a federal government shutdown as well as sovereign credit downgrade is possible.

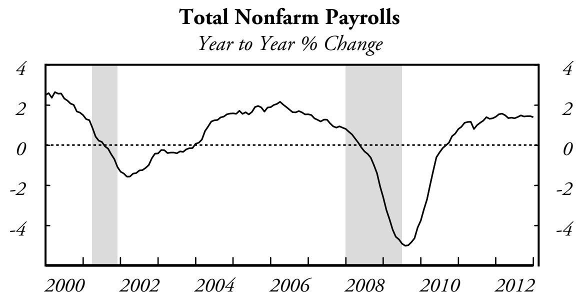
Another "budget battle cliff" by March.

Indicators point to modest growth in 2013.



The various monthly indicators that chart the current and future course of the economy are mixed but on balance point toward continued modest growth. The Index of Leading Economic Indicators was down modestly in the most recent release reflecting the impact of Hurricane Sandy. The index is a composite of eleven economic data points including initial unemployment insurance claims, new orders for consumer goods, plant and equipment orders, building permits and consumer expectations among others. It is designed to provide a forecast of the direction of economic activity six to nine months in the future. Three consecutive months of positive change suggest continued growth while three consecutive months of negative change suggest a possible downturn in economic activity in the out months. The Index peaked at year-over-year growth of 10.2 percent in April 2010 and has been trending downward since. In the most recent reading the Index was 1.8 percent above the year-earlier level. The impact on GDP of the tax changes is a negative 0.5 percent and will affect the first half of the year. Combining the current economic data with the tax changes, and barring a federal government shutdown, we expect GDP to grow at an annual rate of 1.5 percent in the first half of 2013 and 2.5 percent in the second half of the year.

Employment growing at sub-par rate.



The employment situation continues to improve but at a rate well below that of prior economic expansions of the same length. In December non-farm payrolls rose by 155,000 and the unemployment rate held steady, from a revised prior month, at 7.8 percent. Since the peak of the employment cycle in January 2008, there are 4.4 million fewer workers. There are 12.3 million people officially unemployed and another 6.3 million who have dropped out of the labor force, people who want a job but have stopped looking for one. If they were part of the labor force the unemployment rate would be 11.7 percent. Additionally, there are 8.0 million people working part time who would like to work full time.

The United States may have a structural labor problem. The labor force participation rate has fallen to its lowest level in three decades. The labor force is defined as those people between the ages of 16-64 who are either employed or unemployed and looking for a job. Adjustments are made for students, homemakers and retirees under the age of 65. The labor force as a percentage of the total population is the participation rate. Over the past several decades, the participation rate has averaged about 66 percent. When the recession ended in June 2009, the labor force participation rate was 65.7 percent. In December 2012 it was 63.6 percent, 0.1 percent above the August cycle low, the lowest since 1981. This means that over 6 million qualified people are no longer looking for work. University of Chicago economist Casey Mulligan contends that the large increase in welfare benefits to those who do not work, including unemployment insurance, Medicaid, food stamps, disability payments, etc., provides a disincentive to work. These welfare benefits, which exclude Social Security and Medicare, exceed $1 trillion annually. To the extent that they discourage work, they have a double impact on the federal budget in that these people do not pay income, Social Security, Medicare and other employment-related taxes and are receiving payments from the government that they would not receive if they were working. What role have these social safety net payments played in creating a permanent welfare dependency class?

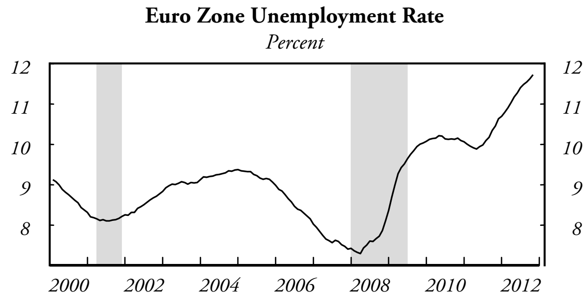
Housing market recovering.

Housing ended the year on a positive note with its best performance since the housing collapse began in 2006. New and existing home sales, housing starts and home values all experienced upward trends during 2012. The S&P Case-Shiller Home Price Index has risen for nine consecutive months and is 4.3 percent above year-earlier levels. New home sales are 15 percent above year-earlier levels and the inventory of new homes for sale is at a 50-year low. The combination of home prices, low mortgage rates and personal income, the favorability rating for home buying, is at its most attractive level since data have been kept. The increase in home values and decline in mortgage debt have improved household net worth. The housing recovery has a long way to go to undo the damage of the downturn. About $5 trillion of home equity has disappeared since the mid 2000s. Nonetheless, homeowners' equity as a percent of the value of the home has climbed from a recession low of about 36 percent to 45 percent. The post-WWII mean is 64.3 percent. Should this trend continue it will lay the foundation for improved consumer sentiment and spending. However, housing remains depressed by historical standards. In the fourth quarter it only represented 2.4 percent of GDP, about half of the long-term average.

China's economy has stabilized.

In December Japanese voters elected a new prime minister who promises to lift that country out of its prolonged economic and deflationary slump. Mr. Shinzo Abe's Liberal Democratic Party and his coalition partner will have a supermajority to push though pro-growth policies to lift the country out of its deflationary cycle. If he and his policies are successful in promoting economic and employment growth for the world's third largest economy, behind the United States and China, it will have a positive impact on the global economy. China's new leadership which took over in the fall of 2012 has stated that its priority is to shift the economy in the direction of domestic demand and imports and less reliance on exports. This will be aided by encouraging the immigration of rural workers to urban areas as this will lift wages and in turn increase domestic consumption. Urbanization is "the biggest potential driver of domestic demand" according to a statement released by China's Central Economic Work Conference after its annual meeting in December. In 2011, over 50 percent of China's population was urban for the first time. Recent economic data for China have turned up with positive reports for manufacturing and housing.

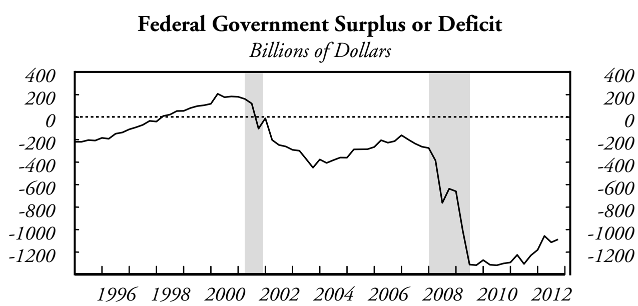
Euro zone in recession.



The 17-nation euro zone is in recession. The European Central Bank (ECB) is forecasting a 0.5 percent decline in GDP in 2012 followed by a 0.3 percent decline in 2013. The creditor nations in the northern tier of the zone have had some success recently in forcing reforms in the debtor countries in the south. However, there is much to be done to save the euro zone in terms of further fiscal discipline, reforming rigid and immobile labor markets, paring excessive healthcare and retirement benefits and other welfare spending, and reducing burdensome regulation and taxation. The International Monetary Fund, the ECB and the European Economic Community together with the establishment of a permanent bailout facility (the European Stability Mechanism) have temporarily relieved the sovereign debt crisis, but it has not gone away.

Despite some reforms, risks to euro zone remain.

Government regulatory policies have harmed small business and capital formation.

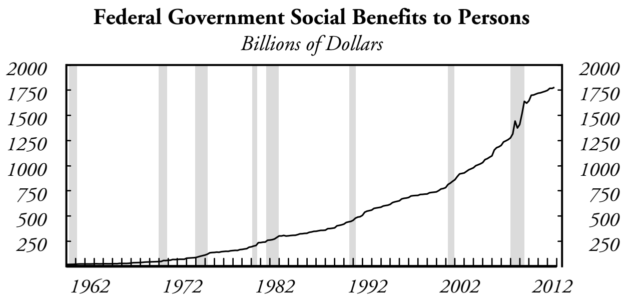


As we enter 2013, the United States is faced with both short- and long-term challenges. Over the short term the U.S. must address the revenue shortfall and spending excesses that result in budget deficits. The recently passed legislation to avoid the fiscal cliff does not address these revenue and spending issues. The higher tax rates on the top income earners will only reduce the deficit by 6 percent, everything else being equal. But everything else is not equal as people will change their behavior to avoid taxation and the anticipated increase in revenues will not occur. The shortfall in revenues from their historic level of 18.3 percent of GDP to the current level of about 16 percent is not a tax rate problem but a revenue generation problem caused by underemployment. In the 2007 fiscal year before the recession, revenues as a percentage of GDP were 18.7 with the same tax structure that existed in 2012. The problem is employment. There are 4.4 million fewer employed currently than at the peak of the last cycle in late 2007. Additionally, if non-farm payrolls had grown at the same pace in this economic recovery as in past recoveries and the labor force participation rate were at the same level as prior to the recession, there would be an additional 12 million workers. Government revenues from taxes associated with this added employment would bring revenue as a percentage of GDP to its historic level of about 18 percent. This added employment would also reduce government spending by about 1 percent of GDP through lower safety net outlays (unemployment insurance, food stamps, etc.). The federal government is spending about $3 billion a day more than it is collecting in revenue. The federal budget deficit is running at an annual rate of about $1 trillion. The fiscal cliff avoidance agreement does not change this. The debt ceiling needs to be increased from the current $16.4 trillion within the next three months and the mandated spending cuts need to be addressed to avoid another crisis.

High U.S. debt to GDP has dampened economic growth.

The employment problem of the past five years is due to below average GDP growth of the current economic recovery. This tepid pace of economic growth is in part a function of government policies that provide disincentives to work, the past uncertainty of future tax rates, excessive regulation that has been particularly harmful to small businesses and capital formation and the growth of federal debt relative to GDP. The Small Business Administration concluded in a study in 2011 that the annual regulatory cost to small business for Environmental Protection Agency (EPA) harassment alone is $10,585 per employee. Other studies on compliance costs of Sarbanes Oxley, Dodd-Frank and the Affordable Care Act indicate that they are particularly burdensome to small businesses, the genesis of most job growth. Many studies conclude that a ratio of sovereign debt levels to GDP above 90 percent for sustained periods subtracts about one third from GDP growth. Total U.S. sovereign debt represents 108 percent of GDP.

Entitlement programs are unsustainable.



The second challenge is long-term reform to the nation's entitlement programs of Social Security, Medicare, Medicaid and some fifty other welfare benefits. Some 97.7 percent of households with a person aged 65 or older receive a government benefit, 34.8 percent of households without a person 65 and over receive at least one government benefit and of all families 47.8 percent receive a transfer payment from the federal government. The present value of these future unfunded liabilities exceeds $100 trillion, or over six times the total annual output of all goods and services in the United States. State and local governments have unfunded pension and healthcare liabilities that exceed $5 trillion. Currently, entitlement transfer payments consume two-thirds of all federal spending. Stated another way, the following percentage of households receive Medicare, 29%; Medicaid, 19.5%; Social Security, 31.6%; food stamps, 12.7%; subsidized lunches, 11.2%; public housing, 5%; unemployment insurance, 4% and direct cash payments, 7%. There is obviously quite a bit of overlap on several of these programs, especially Social Security and Medicare as these two mainly benefit retirees. In 1983 about 29 percent of American's population lived in households receiving at least one government benefit compared to 48 percent in 2011, an increase of 65.5 percent. There are not enough people in the U.S. to tax to sustain these programs.

The U.S. is facing insolvency unless entitlement programs are reformed.

American politicians have failed to master the craft of governing. They are incapable of making the difficult decisions regarding the solvency of the country, praying to be held harmless and escape the condemnation of posterity as they pass to future generations a bankrupt nation.

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