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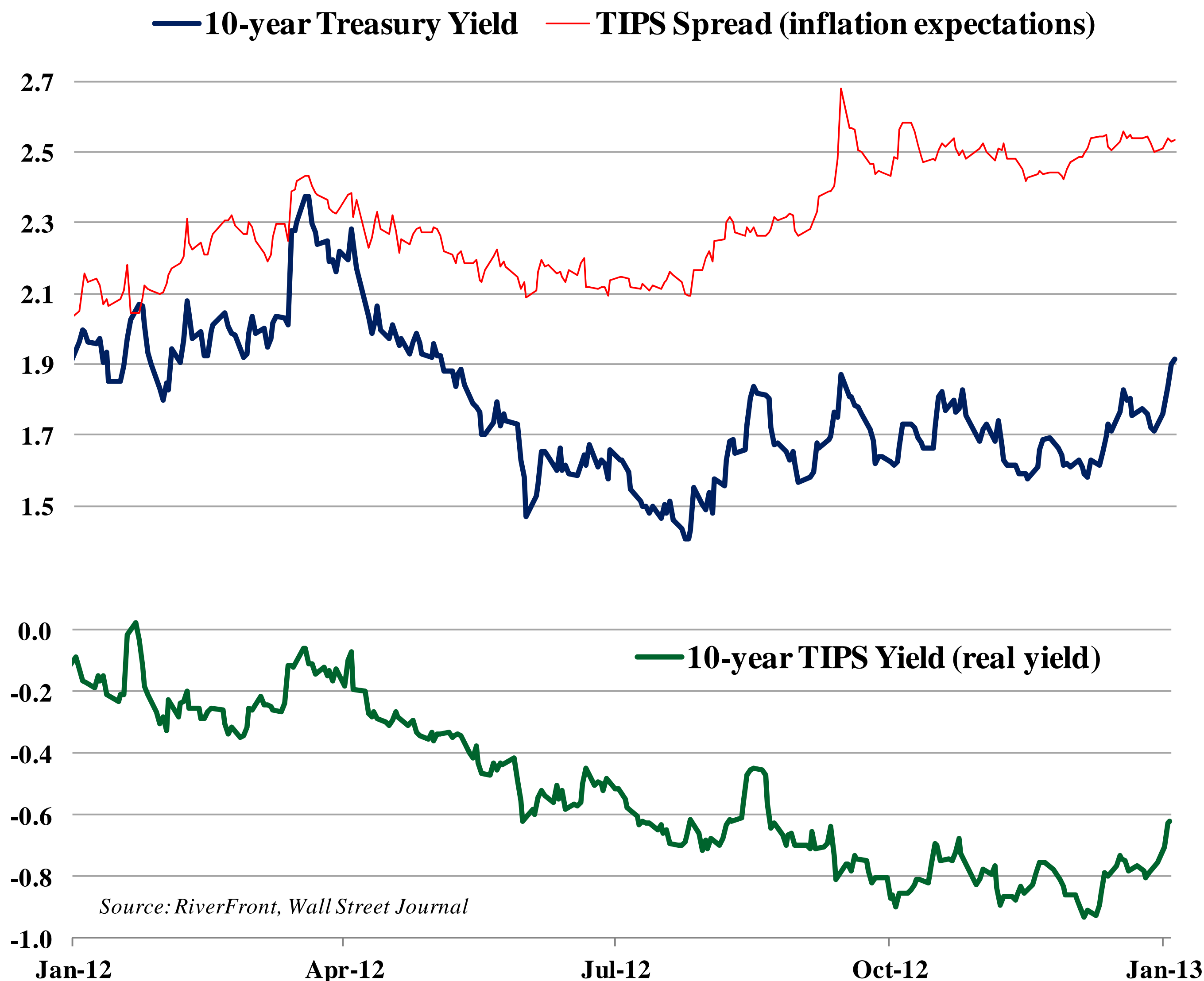
Tax Deal Lowers Recession Risks: Good for Stocks, Bad for Bonds

We think the risks of a 2013 recession are low – the fiscal cliff is turning out to be more of a slope, with Congress splitting up the issues of spending and taxes and finally agreeing to permanently keep most taxes from rising. The S&P 500 responded, justifiably in our view, to this political détente with a 2.8% gain last week to 1466, just above last September's closing high and the highest in four years. We see technical support around 1400, with upside potential to 1550. Equally, we are not surprised by last week's upside breakout in bond yields (see Weekly Chart). While Washington's progress so far is consistent with RiverFront's 'muddling through' baseline case for 1.6% GDP growth (see *Outlook 2013: Emerging from Policy Purgatory*), it offers little hope of anything better, in our view.

Left unanswered last week were spending-cut decisions and whether the debt ceiling will be lifted, which will have to wait until March. However, because failure to lift the debt ceiling would be potentially damaging (recall the debt ceiling debates in 2011), we believe there is little appetite for a repeat this year. Furthermore, we think a spending-cut induced recession is also unlikely for the same reason that the tax relief bill was eventually passed: it is in no parties' interests to cause (and/or be blamed for) a recession. Rather, discussions surrounding deficit reduction appear to be gravitating towards long-term tax and entitlement reform and away from immediate cuts in discretionary spending.

Key economic indicators continue to support modest growth. The US purchasing managers index (PMI) for manufacturing rose 1.2 points in December to 50.7, suggesting slight expansion in business activity. We expect business investment to rebound further as fiscal issues are resolved. Similarly, the global manufacturing PMI rose just above 50 with an increasing share of the world moving into expansion territory. US job growth remained steady last month, with gains of 155,000, in line with 2012's monthly average of 153,000. As a whole, the US economy added 1.8 million jobs last year. Growth of aggregate payrolls (hours worked times hourly earnings) was more impressive, accelerating to 3.8% year over year. With CPI inflation still subdued at 1.8% year over year and house prices up around 5% nationally, we think consumer spending will continue to post modest growth.

THE WEEKLY CHART: RISE IN BOND YIELDS REFLECTS BETTER ECONOMIC DATA



10-year Treasury yields (top panel in the chart) broke out above the five month trading range that followed July's all-time low. We believe the breakout has been driven by improving economic activity rather than a rise in inflation expectations. This is illustrated by10-year TIPS (Treasury Inflation-Protected Securities) yields, which at -0.62% are up 0.31 percentage points from their record low on December 6, while inflation expectation (measured by the difference between nominal and real yields) have remained anchored around 2.5% since August. If inflation expectations remain contained and the Fed continues to print money at an $85 billion monthly rate, money supply growth in excess of economic growth will push up asset prices including stocks, in our view. Without a substantial fall in inflation expectations, however, bonds will underperform in our base case scenario of economic improvement.

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