QUARTERLY ECONOMIC NEWS

Fourth Quarter 2012

The fourth quarter of 2012 was action-packed: a presidential election, a destructive hurricane, and the fiscal cliff negotiations kept the nation on its toes. President Barack Obama was reelected to a second term after a close, and costly, race with Republican rival Mitt Romney. With approximately $1 billion raised on each side—based on a tally from the Federal Election Commission—the 2012 electoral campaign was the most expensive in American history. With the elections squared away, the nation's focus shifted to the fiscal cliff negotiations. Public sparring between President Barack Obama and House Speaker John Boehner did nothing to reassure the American people that a deal could be reached before year end. In a year filled with multiple natural disasters, Hurricane Sandy was the single costliest event (estimated at $60 to $70 billion in damages).

Economic News

The employment situation remained relatively stable with the unemployment rate hovering just under 8% in the fourth quarter of 2012. The Federal Reserve announced specific thresholds for its monetary easing measures, stating that rates will remain low as long as the unemployment rate is above 6.5% or providing inflation is at 2.5% or less. U.S. holiday retail sales grew at the weakest pace since 2008, when the nation was in a deep recession. Analysts blamed the weather and worries about the fiscal cliff for putting a damper on holiday spending. Holiday sales are an important indicator of the economy's strength: November and December typically account for a substantial portion of annual sales for many retailers. On a bright note, the third estimate from the Bureau of Economic Analysis reported that real gross domestic product increased at an annual rate of 3.1% in the third quarter of 2012, compared to 1.3% in the second quarter. The increase in the GDP primarily reflects a modest pickup in personal consumption expenditures (PCE), and a downturn in imports. The GDP growth rate surpassed economists' expectations, but remains historically low. In the fourth quarter, the markets were mainly driven by headlines. The following table highlights the average annual returns for various indices:

Index	4th Qtr	1 Year	5 Year	10 Year
S&P 500 (Composite Total Return)	-0.38%	15.99%	1.66%	7.10%
Russell 2000	1.85%	16.35%	3.56%	9.72%
MSCI EAFE (Price)	6.17%	13.55%	-6.57%	5.35%
Barclays Aggregate Bond	-0.09%	2.62%	5.57%	4.91%

The S&P 500 is a commonly used measure of common stock total return performance, the Russell 2000 is a commonly used measure of small capitalization stocks, the MSCI EAFE is a commonly used measure of common stock total return performance of international markets, and the Barclay's Aggregate Bond Index is a commonly used measure of the bond market. All referenced indices are unmanaged and not available for direct investment. Past performance is not a guarantee of future results.

Unwinding TARP

The U.S. Department of the Treasury's efforts to wind down its investment in the Troubled Asset Relief Program (TARP) have been fruitful. As of mid-December 2012, the Treasury had recovered more than 90% ($381 billion) of the funds disbursed during the economic crisis. In a press release on December 14, the U.S. Department of the Treasury announced it had received payment from its final sale of AIG common stock. The Treasury and the Federal Reserve fully recovered the combined $182.3 billion they committed to AIG, and benefited from an additional positive return of $22.7 billion.

The Treasury also benefited from a $23 billion positive return through repayment, dividends and other income from the TARP's Bank program (there are 218 banks currently remaining in the program, down from the original total of 707). In 2013, the Treasury expects to conduct auctions for the preferred shares or subordinated debt in approximately two-thirds of the remaining banks. The majority of the remaining banks that are not auctioned will repay the Treasury's investment at par.

In a deal announced on December 19, the Treasury would divest itself from 500.1 million shares of General Motors' (GM) common stock gradually within the next 12 to 15 months, subject to market conditions. GM committed to purchasing 200 million shares from the Treasury at $27.50 per share before the end of 2012. The Treasury has recovered a little over half of its investment in GM, but a loss is likely in the sale of its remaining shares.

Let's Make a Deal

Compromise was a four-letter word in Washington, as political leaders went multiple rounds to craft legislation that would pull the nation back from the brink of the so-called fiscal cliff. After keeping Americans in a constant state of angst, the 112th Congress managed to come up with a stop-gap measure, at the eleventh-hour on January 1, which blocked most impending tax increases. The "compromise" bill was nowhere near the grand bargain the President had envisioned after the November elections. Automatic spending cuts (sequestration) were postponed for two months, and are likely to be addressed when Congress tackles the expected increase of the nation's debt limit in February.

The list below contains the highlights of the new American Taxpayer Relief Act of 2012:

- Tax rates remain the same for singles earning up to $400,000 and couples earning up to $450,000. Above this income level, the marginal tax rate increases to 39.6%.
- Certain personal exemptions are phased out for individuals with $250,000 of taxable income and joint filers with $300,000 or more of taxable income.
- Capital gains and dividend tax increases to 20% for the highest earners ($400,000 individual taxable income, $450,000 joint), and remains at a maximum of 15% for all other taxpayers. The highest earners will also be paying a 3.8% healthcare surcharge on investment income.
- The Alternative Minimum Tax (AMT) threshold has been permanently indexed to inflation.
- The Estate Tax exemption has been set at $5 million and the maximum estate tax rate at 40%.
- The payroll tax holiday has expired, bringing the rate back to 6.2% on the first $113,700 of earned income.

Aftermath of Sandy

In October 2012, Hurricane Sandy traveled from the tropics to Canada and caused significant damage in several countries along the way. Within the United States, Mid-Atlantic states–New York and New Jersey, specifically–bore the brunt of the damages. Early estimates of the total cost of the storm's damages range from $60 to $70 billion, with the vast majority of damages occurring within the United States. Included in this figure are damages to homes, businesses, parks, and other properties, as well as missed business due to closures during and after the storm. As of December 28, 2012, the Federal Emergency Management Agency ("FEMA") had deployed 4,402 personnel and approved $1.14 billion of assistance in response to the storm; however, assistance from FEMA covers only a fraction of the storm's costs. Thus far, Congress has passed legislation to provide an additional $9.7 billion in aid, and a more expansive federal relief package goes to vote on January 15. At a time when the topic of fiscal responsibility continues to dominate headlines, Hurricane Sandy has evoked some support for the federal government from individuals who historically have advocated for smaller governments. Federal aid packages sought by New York and New Jersey include both repair and renovation. The year's largest domestic storm brought attention to the antiquated infrastructure that exists in many regions of the United States. Critics were quick to suggest that several fires, floods, and explosions that occurred during the storm might have been avoided, or lessened, with more modern infrastructure, which could have substantially lowered the cost of the damages. Whether it be rebuilding stronger roads, securing power plants, or moving power lines below ground, it seems inevitable that Hurricane Sandy has rekindled a debate on the need for investing in American infrastructure in order to limit damage in future storms. When viewed in the context of the larger national debate surrounding appropriate levels of federal funding and spending, this discussion is even more compelling. Long after the rebuilding and relief efforts have ended, Hurricane Sandy may well continue to serve as a prime example in conversations regarding the appropriate "size" of the federal government.

Housing Market Trends

The housing market stayed resilient in the fourth quarter, and continued to show signs of recovery. Mortgage rates remained close to historic lows and home prices are trending upward. In the *2012 Profile of Home Buyers and Sellers*, the National Association of Realtors looked at the subtle shifts in how homes are purchased and sold. In 2012:

- the typical home buyer searched for 12 weeks and viewed 10 homes (which is fewer than in previous years).
- the typical home purchased was 1,900 square feet, built in 1992, and had three bedrooms and two bathrooms.
- sellers typically sold their homes for 95% of the listing price, and 60% reported they reduced the asking price at least once.

Conclusion

As we head into the new year, Americans should look for signs of economic recovery in unconventional places such as new restaurant openings, upscale hotel occupancy, renewed interest in leisure investments, and auto sales. Light-vehicle sales in the U.S. have been growing at a steady pace since 2010 according to the Alliance of Automobile Manufacturers. After years of gloom and doom, looking at the economic recovery in a fresh way is certainly more entertaining than depending solely on economists' predictions.

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