It's All About the Cliff…

…but, selectively speaking—still better long than short!

Brian Langenberg, CFA

We anticipate sluggish near-term growth driven by inventory re-stock, improved residential housing and momentum in particular end markets—e.g. commercial aviation, resource extraction (coal and slowing natural gas) and power transmission and distribution.

Elections have consequences. Posturing was inevitable no matter who won, but decision makers will continue to sit on their hands until D.C. firmly establishes some ground rules regarding tax rates. Meanwhile, we are skeptical of any real improvement in the regulatory environment. If anything, we remain concerned about incremental employment growth (healthcare impact on service-oriented employment growth); availability of qualified labor (public schools: mostly bad; vocational training: not meeting need) and deteriorating infrastructure (roads, bridges, grid).

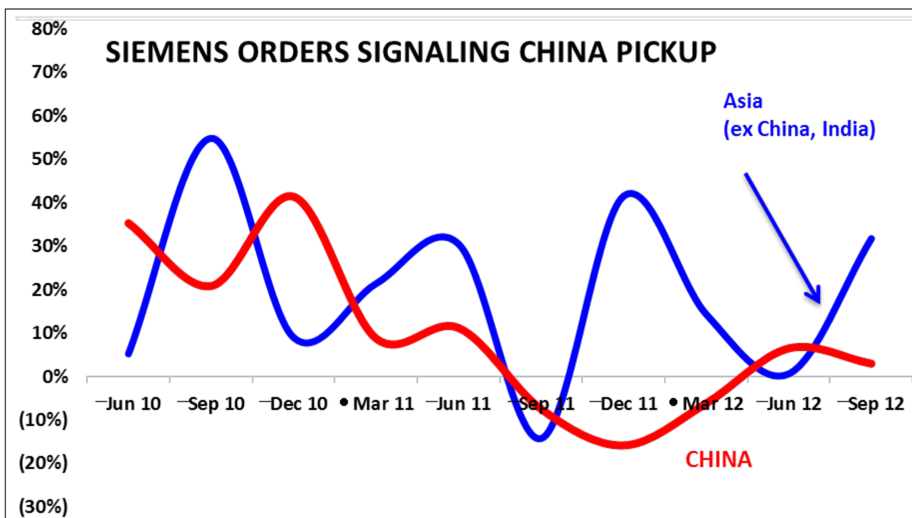
At the moment the administration thinks, or is at least acting, like it has a mandate for sharply higher taxes with little curtailment in spending. On the other side, Republican senate minority leader Mitch McConnell did not achieve his goal of making President Obama a one-termer, but do recall that he *was* the guy who stood ground and rallied his party after 2008 when Democrats had the run of the table. It is delusional to think he is going to back down this time around, either. The reality is that, for most people, "who is right" is linked to "how they voted." Regardless—what is required now is a centrist approach with mutual compromise.

The range of possible outcomes is considerable—and on the road to reaching one we can count on much noise, carping and pundit-infused bloviating from all of the news outlets—with one's political leanings dictating which of them hold our attention. But in the spirit of much-needed, reasoned discourse, here is our view of the range of scenarios:

- **"Grand Bargain": 1 percent probability.** This would be the smart way to do it, meaning of course it is DOA during a lame duck session. Such a deal would have three components: 1) lower corporate taxes (everyone agrees); 2) higher income tax revenue (Republicans are for reducing deductions, Democrats for higher rates); and 3) entitlement reform—i.e., raising retirement age, means testing benefits (which Dems are unwilling to negotiate).
- **Muddle through: 85% probability.** Extend most Bush-era tax cuts—along with payroll tax relief—and borrow more while hammering out a real budget. This is the easiest (read: most politically expedient) thing to do and thus the most likely.
- **A Republican rollover: 1% probability**. This is not going to happen; McConnell will see to it because the last election was not a mandate for more government. Tea Party and religious conservatives are the party base and nearly half the electorate. Senior Republican leadership (often an oxymoron) will focus on two achievable goals: 1) fixing the immigration position; and 2) ditto the Repubs' senatorial candidate vetting process. Both will involve educating, and some accommodation with, its base.
- **Thelma & Louise, a.k.a. Fiscal Cliff: 13 percent probability**. This… can happen. And… the odds have increased since November sixth. It does not matter what I think should happen nor what you think should happen. It also doesn't matter what the media, CEOs or Europe think. What *does* matter in this scenario are the goals, agenda and political calculations of just a few players.

We do expect a deal providing sufficient clarity for business decisions to be made. Will such a deal be perfect or enough to deal with long-term issues? As we said, a "Grand Bargain" probability is 1 percent at best in the near-term. But as long as some sort of palatable deal is brokered there is reason for optimism. That said—and assuming some kind of deal is cut…

China is positioned to accelerate in second-half 2013. The drivers are pretty clear. After putting on the brakes in 2011-2012 to deal with rampant inflation and real estate speculation, coupled with an unusually public and tense "transition year" with respect to leadership, we expect China to step on the gas. We do not take the view that China can, or will, drive the global economy, but it remains a major component. Certain pieces are already in place; easy comparisons—signals that increased raw material purchases—are anticipated and a new political leadership team eager to come out of



the blocks fast and secure power will lead to a growth-oriented agenda.

European exporters would benefit. Even a modest tailwind for motors, drives, and power-related infrastructure could do wonders for the margins of a range of companies and we anticipate China picking up will help.

Signs of improvement already exist. Part of the client work we do here is monitor and analyze key data from over 55 global industrial companies. Several provide regional order detail and, as shown above, the Siemens order patterns are suggesting we are, at worst, in only a lull.

The U.S. economy should continue to improve, albeit gradually. Housing and automotive demand continues to rise. In particular, residential housing growth is slated to grow 11-13 percent for the next couple of years—well below historical norms but consistent with a weak recovery. And though improving home prices could prove to accelerate a turnaround, we suspect the length and depth of this most recent downturn has materially impacted societal views about leverage, debt and home price appreciation for at least the next few years. Still – it's enough to drive continued higher demand for construction/rental equipment and at least maintenance capital spending. Barriers to faster growth remain, as whatever combination of spending cuts and tax increases will serve as a headwind.

The rest of Asia a good leading indicator on China industrial activity and, as noted, the last quarter pick-up in orders suggests that at least modest gains are in our near future. While construction equipment demand will be down for at least 2-3 quarters (we think 3-5), we note that process automation never slowed and we anticipate a pick-up in industrial automation (motors, drives), construction-related (low-, medium-voltage) and transportation infrastructure (rail). We think this will serve as a catalyst for not only direct Asian demand but also as a catalyst for European exporters of heavier capital equipment.

S&P 500: 1386.4

P/E	S&P 500 Earnings $93	$105	$112	Price Return		
14x	1,302	1,470	1,568	(6%)	6%	13%
15x	1,395	1,575	1,680	1%	14%	21%
16x	1,488	1,680	1,792	7%	21%	29%
17x	1,581	1,785	1,904	14%	29%	37%
18x	1,674	1,890	2,016	21%	36%	45%

SKY IS FALLING	S&P 500	Impl. Ret.
5/6/09 Armaggedon	683.38	(51)%
8/19/11 US Downgrade	1123.5	(19)%

% Prob.	
1%	Grand Bargain - lower corporate, < loop holes.
85%	Short-term deal, argue in 2H13
1%	Obama Steamrolls Mitch McConnell on taxes
13%	Fiscal Pothole
100%	

In our view, the markets implicitly assume a "muddle through" agreement. Should we slide well past the New Year without a deal, I suspect markets would start to react in a very material way.

Consensus estimates for the S&P 500 Index are about $102 in 2012 and $112 in 2013. However, given estimate revision trends (down) and common sense (acquired via the tread marks on my back from being in the business for 24 years) we will plug in $105.

In our view, there is a high likelihood of positive returns (pick your flavor as to magnitude) as long as earnings come through and the market P/E holds at about 14X.

There is a small likelihood—but potentially *very painful*—if it occurred—of *significant* declines.

How significant? Let's eliminate the guesswork and ponder the two worst downdrafts in the past five years:

1. The 2009 low (- 51 percent)
2. The downgrade of the U.S. by S&P in 2011 (-19 percent)

My sense is that—should we find ourselves come January in "full-cliff," extended-free-fall mode—and resulting full recession—that "down" could mean a realistically achievable 20 percent slide. Like most participants in the market, I do not think it will happen.

And so, better long than short—but, *selectively*. Our institutional and high-net-worth investor clients know where we stand; i.e.—only on to between hold and those things in which their intrinsic value means you are being "paid to wait" (e.g., General Electric, Tyco International). Or, for those who must be invested, we point also to United Technologies and Dover Corporation as offering "market-plus" returns. **PTE**

Brian K. Langenberg, CFA, has been recognized as a member of the Institutional Investor All-America Research Team, a Wall Street Journal All-Star, and Forbes/Starmine (#1 earnings estimator for industrials). Langenberg speaks and meets regularly with CEOs and senior executives of companies with over $1 trillion in global revenue. His team publishes the Quarterly Earnings Monitor/Survey—gathering intelligence and global insight to support decision-making. You can reach him at *Brian@Langenberg-llc.com* or his website at *www.Langenberg-LLC.com*.