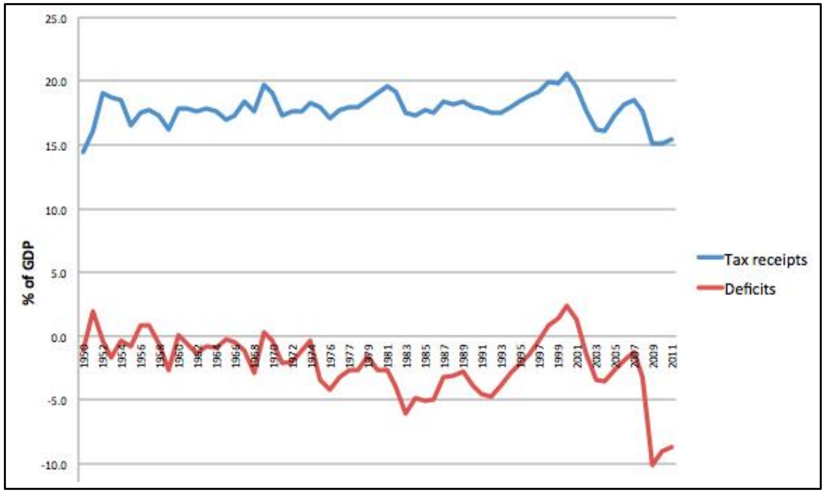
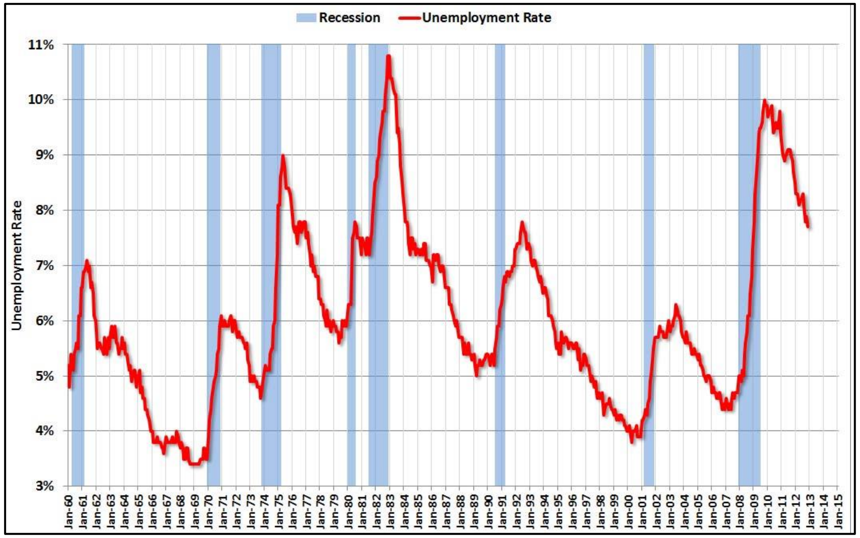
Market Recap

Tax Revenue and Deficit as % of GDP



Source: Office of Management and Budget

U.S. Unemployment Rate



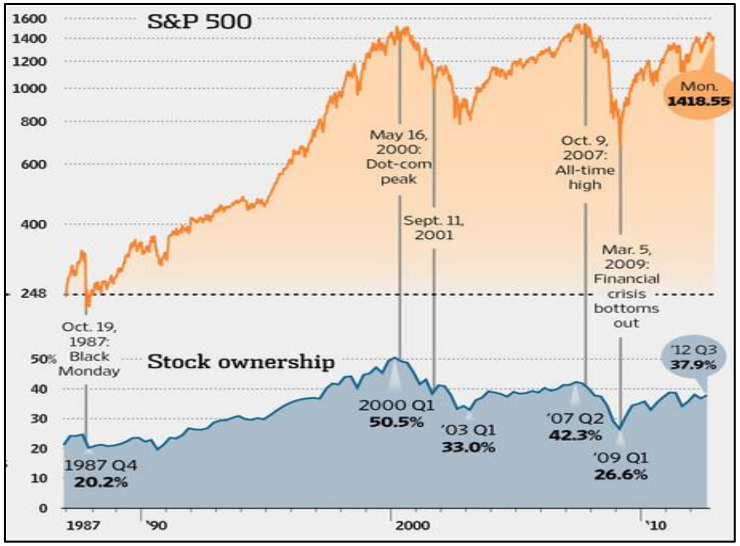
Source: Bureau of Labor Statistics

Since 1950, federal tax revenue has averaged 17.8% of GDP. Government spending has historically averaged 21% of GDP, leading to the growing federal deficit. During the ongoing fiscal cliff discussions Democrats have highlighted that, relative to the size of the economy (GDP), U.S. tax revenues are comparatively low, ranking 23rd among the 25 most developed economies. Republicans have emphasized that tax revenue actually rose above the historical average in 2007 to 18.5% with the Bush tax cuts. Further, they contend that, if the Bush tax cuts were made permanent, annual tax revenue would average about 18% (above the historical average) of GDP through 2021. Many believe that there must be a greater focus on the spending side of the ledger, since spending of 21% of GDP far exceeds both average past and average projected revenues.

The Federal Reserve announced that it did not expect to increase short-term rates until the unemployment rate (currently 7.7%) falls to 6.5% or lower, as long as inflation forecasts remain near the 2% target. According to the Fed's economic projections, the targets would keep short-term rates near zero into 2015. The Fed also said that it would enter 2013 with a plan to purchase $85 billion a month of mortgage-backed and Treasury securities as part of the continuing attempt to lower long-term interest rates, thus encouraging borrowing, spending, and investing. Many analysts say the economy has slowed to a near-crawl in the final months of 2012, held back in part by uncertainty over fiscal policy. Many critics of the central bank believe it has already gone too far in its quest to boost economic growth, and they say it might be exposing the financial system to new risks of inflation or even a financial bubble by pumping so much money into the system, with little reward to show for it.

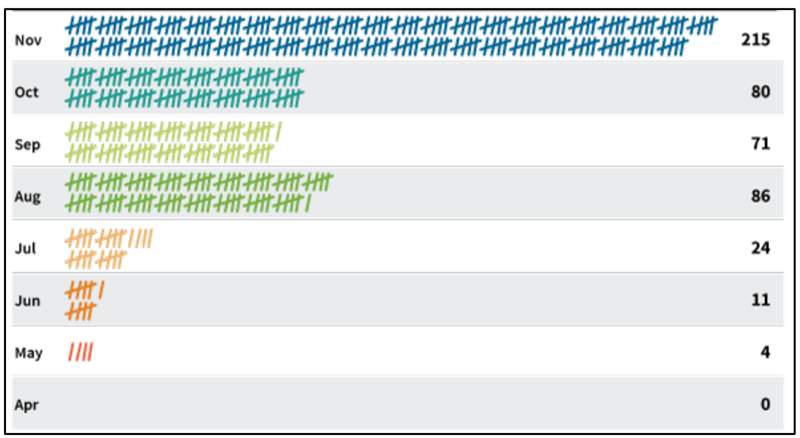
Market Recap

S&P 500 and Stock as % of Household Assets



Source: WSJ Market Data Group; Federal Reserve

"Fiscal Cliff" Mentions in 2012 SEC Filings



Source: SEC Filings; Reuters

The S&P 500 has more than doubled in value since the recession low of March 2009. However, the market rally has been one that has not engaged wide participation from average individual investors. After two stock collapses in one decade (2000-2002 and 2007-2009), coupled with Wall Street scandals and concerns over Washington's ability to rein in debt, individual investors continue to be wary of the market. Investors have withdrawn a net $900 billion from U.S. equity mutual funds since January 2000. Stocks currently make up 37.9% of the average U.S. household's financial assets, down from 50.5% in 2000. Despite their low yields, investors continue to flock to the safety of bonds and money market funds. Given the current economic uncertainty, many believe that the directional flow of funds will not materially change in the near future.

The looming fiscal cliff has paralyzed individuals and businesses, restricting many financial and capital spending decisions. The trend will only worsen if lawmakers cannot come to an agreement soon. Uncertainty surrounding the impending spending cuts and tax hikes has led companies to worry about a possible recession or at least to use the fiscal cliff as an explanation for sluggish growth. As we approach year-end, the frequency with which the term "fiscal cliff" has been mentioned in SEC filings has increased rapidly. November saw 215 references to the fiscal cliff, almost triple the number of mentions in each of the previous three months.

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