

Outlook 2013: Challenges and Opportunities

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“You can never plan the future by the past”

Edmund Burke, Irish statesman (1729-1797)

Prognostications about the New Year have become a regular feature of Wall Street newsletters. As James Spencer pointed out in the Fall 2012 TrustLetter, future events rarely play out as we envision them and this is especially true in the investment business. With this in mind, we endeavor to present a survey of the current economic and investment landscape and discuss some of the investment opportunities we have identified for our clients.

The Challenges

Over the last three years investors have been inundated with a steady stream of economic and geopolitical challenges. In the United States, the persistently high unemployment rate and a lack of progress on resolving the federal budget deficit have been two of the most stubborn challenges. After three years of an economic recovery, unemployment in the U.S. remains at 7.9%, which is above the average of 6% for economic recoveries since 1950 (ISI Group). Several trends have worked to keep the unemployment rate elevated during the current recovery: Between 2006 and 2009, residential construction, which is quite labor-intensive, collapsed and, as a percentage of GDP, declined from 5% to less than 2% and this has caused higher unemployment in this important sector of the economy (Bank Credit Analyst). The aging of the workforce is another factor influencing unemployment. Unemployed workers in the 45-55 age bracket stay

unemployed, on average, 45 weeks vs. 35 weeks or less for workers aged 20-35 (Bureau of Labor Statistics). With the front end of the baby boom generation recently turning 65 years old, this is an important demographic contributor to unemployment statistics. Partially as a result of these factors, we expect the U.S. unemployment rate to show only gradual improvement in the coming years.

The U.S. Federal budget deficit has been the focus of public debate since the summer of 2011 and failure to reach a comprehensive budget agreement was a key factor in the downgrade of U.S. debt that year. There is broad agreement on one fact: current federal deficits, which equated to 7.3% of GDP in 2012 (The Heritage Foundation/OMB), are unsustainable and pose a serious long-term risk to our economy and national security. Amidst the partisan debate and brinksmanship, it is becoming increasingly clear that, whatever the shape of a final agreement, federal revenues (i.e. taxes) are likely to rise and federal spending, measured as a percentage of GDP, is likely to fall. Indeed, federal spending as a percent of GDP is currently 23.8% vs. a 65-year average of 19.7%. Federal tax receipts as a percent of GDP are currently 17% vs. a 65-year average of 18% (U.S. Dept. of Commerce).

After much was said about the so-called fiscal cliff, which included a package of more than \$600 billion in tax increases and spending cuts that was to take effect on January 1, 2013, more was said than actually done. In the end, the

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sequestration of spending cuts was postponed until March, while the tax rate for couples earning more than \$450,000 was raised to 39.6% and the payroll tax for all income earners was reinstated. As it is difficult to know exactly how the debate over the upcoming debt ceiling will be resolved or how much Congress will eventually cut spending, forecasting the country's economic activity in 2013 is difficult at best.

The question of the pace of economic growth in 2013 therefore may be best addressed by reviewing where we currently are and what we know. We know that despite the fact that public policy initiatives and uncertainty contributed to a softening in economic activity by weakening business confidence (evidenced by the recessionary capital spending levels the U.S. experienced in the third quarter of 2012), there is much that is going right with the country's economy. Indeed, with U.S. consumers paying down debt, consumer balance sheets have continued to strengthen. Further, the U.S. housing market is showing signs of recovery (through November 2012, housing starts were up 27.1% over the same period last year and the Case/Shiller home price index had risen for eight consecutive months) (Bloomberg, 12/19/12, Housing Starts in U.S. Post the Best Three Months in Four Years, by Lorraine Woellert) and the auto industry has rebounded (seasonally adjusted annual sales hit 15.5 million in November 2012 for the first time since 2008). Finally, and perhaps most important, there is the prospect of the U.S. becoming the world's largest energy producer. Current projections indicate the infrastructure needed to exploit our vast supply of cheap shale gas will be completed by 2014 (International Strategy & Investment, 12/13/12, Review of the U.S. Energy Boom: by Ed Hyman, Nancy Lazar, Dick Rippe, Karina Mayer, Jaewoo Nakajima, Chris Manzenski, Arif Haque). The prognosis of abundant and inexpensive energy supplies (natural gas averaged \$2.66 per thousand cubic feet in the first nine months of 2012, less than half of what it was five years ago) (*The Wall Street Journal*, 10/12/12, The Real Stimulus: Low-Cost Natural Gas, by Daniel Yergin) is fueling a renaissance in U.S. manufacturing, which should benefit the economy for years to come.

Although there will be fiscal drag on the U.S. economy in 2013 (the new taxes are projected to reduce 2013 gross domestic product by 1 to 1.5%), it is possible, as the amount of tax increases and spending cuts become clear and consequently both consumer and business confidence returns, that any fiscal tightening will be offset by an equivalent increase in economic activity.

According to Bloomberg's monthly survey of 80 economists (December 2012), the average forecast for year-over-year percentage growth in 2013 gross domestic product is 2%. Such forecasts however are projecting capital spending at current "recessionary" levels. At a press conference on December 12, Federal Reserve Chairman Ben Bernanke said a tightening in fiscal policy is a "major risk factor" that is already harming investment and hiring decisions by causing "uncertainty" or "pessimism." (Bloomberg, 12/17/12, U.S. Economy Grew 3.1% in Third Quarter, More Than Forecast, by Alex Kowalski) At the same time, a New York manufacturing survey signaled a more optimistic six-month outlook, suggesting factories are poised to rebound should the federal government resolve its impasse over fiscal policy. (Bloomberg, 12/17/12, Factory Rebound Likely If Fiscal Impasse Resolved: Economy, by Shobhana Chandra and Michelle Jamrisko) If Congress can agree on spending cuts, business sentiment may return to more normal levels. It is possible a boost in business confidence could fuel actual growth in 2013 well above the current forecasts of 2%.

In Europe, the sovereign debt crisis of the peripheral countries (Greece, Spain, and Portugal) has been an ongoing saga since 2010. The response to the crisis has been manifold and it includes debt restructuring, austerity measures, and significant monetary stimulus in the form of sovereign debt purchases by the European Central Bank. The net effect of these efforts has been to avoid a worst case scenario: outright default and the ripple effects across the global economy. Going forward, European economies are still faced with the prospect of additional debt restructuring as well as austerity measures aimed at reducing fiscal deficits, particularly in the southern European economies. The Eurozone economies entered a recession in the third quarter of 2012 and a survey of economists by Bloomberg estimates 2013 European real GDP growth of -0.5%.

Emerging economies in Asia, the Near East, and South America have been a driver of global economic growth over the last decade. These economies face a different set of challenges. China, now the world's second largest economy, is transitioning from fixed-asset growth (housing, and infrastructure) to consumer-led growth. There are a number of implications that arise from this transition including a slowing in the economic growth rate, and reduced demand for natural resources such as iron ore, cement, coal, and crude oil. Slowing growth in China has had a "knock on" effect in developing countries that supply China with natural

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resources. For example, Brazil, a large exporter of soybeans and iron ore, has seen its real GDP growth slow from 2% in 2010 to 0.6% in the third quarter of 2012 (*The Economist*).

Security issues remain at the forefront of global challenges. North Korean missile tests, Iranian nuclear ambitions, and a civil war in Syria are among the most prominent concerns today. Relations between Israel and the Palestinian authority remain tense; the political situation in Egypt also remains fluid. In Asia, China has become more assertive in maritime affairs as demonstrated by the country's newly released maritime policy which extends Chinese borders in the South China Sea.

The Opportunities

As central banks across the globe continue to provide stimulus, global growth will increase in 2013. The Federal Reserve has pumped more than \$2.3 trillion into the financial system, while the Bank of Japan is providing more than \$800 billion and the European Central Bank has made approximately \$1 trillion available in three-month loans to banks (Bloomberg, 12/13/12, *Factory Rebound Likely If Fiscal Impasse Resolved: Economy*, by Shobhana Chandra and Michelle Jamrisko). At the same time, many of the previous risks to global growth have dissipated. The potential for a euro meltdown has receded, as European authorities remain committed to salvaging the euro-area membership including Greece. Concerns of a hard landing in China have been replaced with expectations of renewed growth. Chinese industrial profit growth jumped 20% year-over-year in October. Additionally, recoveries in their Production Managers Index, industrial production, and exports, suggest that a broad-based rebound in the Chinese economy has already begun (BCA Research, 11/30/12, *Global Investment Strategy*).

In Japan, the economy remains subdued, but Japanese stock valuations are compelling. Should Japan's new government prove successful at reinvigorating growth, Japanese companies will perform well. We are not yet convinced Japan can accelerate its growth, but we remain open to adding exposure should the Japanese economic environment improve.

On the other hand, Europe is stabilizing as the euro crisis subsides: borrowing costs for Italy, Spain, and Greece have declined significantly over the past year. For example, Italian 10-year borrowing costs have declined from 6.9% in January 2012 to 4% currently. According to Duke/CFO Magazine's Business Outlook Survey for the fourth-quarter of 2012,

European chief financial officers' economic optimism beat U.S. optimism for the first time in over a year (Ned Davis Research, 11/19/12, *Global Economic Comment, Where are the Happiest CFOs?* By Alejandra Grindal). European equity and bond market returns were strong in 2012 (ranging from 8% to 51%). In 2013, as the European economies recover, above average returns may continue. As they have the potential to deliver superior returns, we continue to add world-class European companies to our portfolios.

The International Monetary Fund's current forecast for growth in developing economies is 5% for the full-year 2013. Although expected growth rates are being reduced as investors recognize the structural transformations that need to take place as these economies mature from the rapid, export-oriented economic model that dominated the last decade to one that is more balanced, less-developed countries continue to be the drivers of long-term global growth trends (Creditsights, 12/9/12, *Strategy Outlook 2013: The Global Economy*). Emerging markets are attractive as their potential for population growth, urbanization, and industrialization remains intact and well above those in the developed world.

Although growth in China is likely to rebound to 8% in 2013 on the back of a 10% increase in exports and a double-digit increase in imports (Creditsights, 12/9/12, *Strategy Outlook 2013: The Global Economy*), we are looking elsewhere in Asia for emerging market exposure. Indeed, Developing East Asia, excluding China, is projected to grow 5.6% in 2012, up from 4.4% in 2011. According to The World Bank's most recent forecast, Developing East Asia, excluding China, will grow 5.7% in 2013 and 5.8% in 2014 fueled by strong performances from Indonesia, Malaysia, the Philippines and Myanmar. As such, we will be concentrating on these areas for our additional emerging market exposure (The World Bank, 12/19/12, *East Asia and Pacific Remains the Bright Spot in a Difficult Global Landscape*, by Keiko Kubota).

Every New Year is faced with challenges, both old and new. The situation in Europe and the slow-paced economic recovery in the U.S. have been with us for some time, while the U.S. debt ceiling and upcoming Sequestration are recent developments in the U.S.'s long-standing deficit debate. Against this backdrop, we still continue to find investment opportunities in both fixed income and equities. Long time clients are familiar with our thematic approach to identifying investment opportunities. Today, we have identified several themes that offer attractive risk/return tradeoffs in an uncertain economic environment.

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American Tax Relief Act of 2012

By Richard A. Moquin, Assistant Vice President and Tax Officer, 617-441-1548

In what undeniably came down to the wire in the early hours of January 1, 2013, the Senate passed the American Taxpayer Relief Act of 2012 (ATRA) which permanently extends the so-called Bush-era tax cuts along with many other provisions. Later the same day the House of Representatives passed ATRA and President Obama signed the bill into law on January 2, 2013. The more than a decade-long fight over the fate of the tax cuts, originally enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), accelerated under the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) and extended by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (2010 Tax Relief Act) came to an end.

Prelude to the Fiscal Cliff

On May 26, 2001, Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). The legislation was hailed as the largest tax cut in twenty years and dramatically changed the landscape of the federal tax code. Two years later, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) was signed into law and accelerated many of the tax cuts set in motion under EGTRRA. Originally set to expire after December 31, 2010, Congress extended these popular provisions for another two years in late 2010 with the passage of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. In 2010, Congress acted before the end of the year to extend the cuts. At the end of 2012, Congress and President Obama engaged in intense negotiations over the “fiscal cliff,” a term that came to combine many federal laws that had a deadline of December 31, 2012, including the Bush-era tax cuts. Congress then passed the American Taxpayer Relief Act of 2012 (ATRA) on New Year’s Day, 2013, effectively averting the fiscal cliff.

What Does This Mean for You?

The new law extends the majority of the Bush-era tax cuts in the same form as they have existed since 2001 or 2003 when initially enacted. All the individual marginal tax rates are retained (10%, 15%, 25%, 28%, 33%, and 35%); however, a new top rate of 39.6% is imposed on taxable income over \$400,000 for single filers and \$450,000 for married taxpayers

filing jointly. The Act makes permanent the lower tax rate on long-term capital gains and qualified dividends of 15% for taxpayers in the middle brackets and the zero rate is retained for individuals in the 10% and 15% brackets. It does, however, increase the rate to 20% for taxpayers above the \$400,000 threshold. The alternative minimum tax exemption amount is permanently indexed for inflation and for 2012 is \$50,600 for single filers and \$78,750 for taxpayers filing jointly.

As for estate, gift, and generation skipping transfer (GST) taxes, ATRA retains the exemption amount of \$5 million and is indexed for inflation. For 2013, the exemption is \$5.25 million. The portability election also has been made permanent which allows a surviving spouse to use a deceased spouse’s unused exemption amount, provided that an estate tax return is filed and the portability election is made. The maximum transfer tax rate has been increased from 35% to 40%. The annual gift tax exclusion also has increased from \$13,000 to \$14,000.

The new law also includes an extension of the popular provision that allows IRA owners to make tax-free charitable contributions from IRAs through 2013. This allows taxpayers age 70 ½ or older to exclude from gross income otherwise taxable distributions from their IRA (qualified charitable distributions or QCDs), up to \$100,000, that are paid directly to a qualified charity. QCDs count toward satisfying any required minimum distributions (RMDs) that you would otherwise have to take from your IRA.

In addition to the above mentioned items, ATRA permanently extends many other provisions, some of which are not affected by the sunset of the Bush-era tax cuts, including:

- Marriage penalty relief
- Inflation protection against the alternative minimum tax
- Deductions for student loan interest and tuition and fees
- Enhanced child tax and child and dependent care credits
- Simplified earned income credit
- Research credits

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American Tax Relief Act of 2012 *(continued)*

- Deductions for state and local sales taxes
- Energy-efficient credits for home and vehicles

Unfortunately, the American Taxpayers Relief Act is significant in what it does not extend in one important respect. It does not renew the payroll tax holiday that had been in effect during 2011 and 2012. As a result, employees and self-employed individuals are paying 2% more employment tax on their earnings up to the Social Security wage base, which is \$113,700 for 2013.

New Taxes

In addition to the various provisions discussed above, some new taxes took effect on January 1, 2013 as a result of health care reform legislation passed in 2010.

The first is an additional 0.9 percent surtax imposed on single individuals who receive wages with respect to employment and income from self-employment that are in excess of \$200,000 for individuals and \$250,000 for couples filing jointly. Essentially this means that when a taxpayer reaches

this threshold the Medicare tax will increase from the current 1.45% to 2.35 %. The second levy imposes a 3.8% tax on the lesser of an individual's net investment income for the year or the amount by which the individual's modified adjusted gross income exceeds a threshold amount. Similar to the surtax on earned income, the threshold amounts are \$200,000 and \$250,000, respectively, for single and married filing jointly filers. Net investment income includes interest, dividends, capital gains, annuities, royalties and passive rental income less allocable deductions, however, excludes tax-free interest or payouts from retirement plans such as IRAs and defined benefit plans. This surtax is also applicable to trusts and estates and takes effect once net investment income reaches the entity's top income tax bracket, which is projected to be \$11,950 for 2013.

The new tax rules under ATRA are comprehensive and complex. As always, it is important to consult with a financial planning professional or tax accountant regarding these new laws and how they may affect you.

Cambridge Trust Profile

Alice J. Flanagan

Trust Officer

Alice J. Flanagan, Trust Officer, joined Cambridge Trust Company in 2011. Prior to Cambridge Trust, she worked at US Trust/Bank of America. Alice received her undergraduate degree from Bentley College and is a Certified Financial Planner (CFP®), as well as a Certified Trust and Financial Advisor (CTFA). She is also a graduate of the Cannon Trust School and holds a Certificate of Financial Planning from Boston University. Alice is a member of the Boston Estate Planning Council and the Trust and Estates Consortium. She is also a member of the Japan Society of Boston. Alice and her husband, Bill, live in Medford, MA.



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The Themes

In the domestic economy, there are several sectors exhibiting strength due to pent up demand, a low interest rate environment, or technological innovation. As previously mentioned, domestic automobile sales for November 2012 were at 15.4 million, a rise of 15% from the prior year and the highest level since 2007 (Reuters). Portfolio holdings **Ford Motor** and **O'Reilly Automotive** are benefitting from the strength in new automobile sales and from the age of the existing fleet which is currently 11 years old (ISI Group).

Residential real estate, which was at the center of the economic downturn from 2008-2009, is showing multiple signs of a sustained recovery. Sales of existing homes rose 10.9% year over year for the month of October 2012; the median price for an existing home rose 11.1% over the same period (Realtor.org). Record low mortgage rates, increasing household formation, and declines in existing inventories are some of the most significant reasons for the rebound in housing. Our holdings in **Bed, Bath & Beyond** and **Target** are direct beneficiaries of the improved housing environment. **Huntington Bancshares** and **PNC Financial** are regional bank holdings that derive approximately 20% of their revenues from residential real estate lending and both companies are benefitting from the increase in housing activity.

Much has been written about the boom in domestic energy production including an article in the Spring 2012 TrustLetter which discussed the impact of technological innovation in the energy industry. Led by a significant increase in shale oil production in North Dakota, domestic crude oil production was expected to reach 6.4 million barrels per day (BPD) in 2012; this represents a 30% increase from 2006 levels and was the highest production since 1998 (U.S. Energy Information Administration). Similarly, in 2011 natural gas production in the U.S. reached record levels. (U.S. Energy Information Administration). **EOG Resources** and **Range Resources** are two portfolio holdings that are almost exclusively focused on North America oil and gas exploration; both companies are achieving significant growth in production volumes and cash flow.

As we noted above, economic conditions outside the U.S. are mixed with Europe in recession and emerging economies in transition. One global theme we have identified is the trend towards more affluent consumers in developing countries and several of our client holdings are benefitting from this trend including **Anheuser-Busch Inbev**, **Nestlè** and **Unilever**. In

a slowing global economy, these three companies grew their earnings per share an average of 15% in 2012 and have an average dividend yield of 2.8%.

Over the last decade, bonds provided investors the best of both worlds. As the yield on the 10-year Treasury note fell from a high of 5% early in the decade to 1.8% today, bonds provided both strong returns and a healthy cushion when stocks were weak.

Unfortunately, with interest rates at all-time lows, future returns from bonds are likely to be much lower (if not negative) and current bond yields simply can't fall enough to provide much of a hedge to stocks. Fortunately, there are other special investment opportunities available for managing overall portfolio risk in a low interest rate environment. Such investments provide competitive, prospective returns less correlated with stocks, thereby dampening overall portfolio volatility.

Given the sizable deficits the United States has amassed, diversifying portfolios beyond dollar-denominated bonds can be beneficial. Many international bonds offer a better hedge against rising rates because their yields are much higher than those available in the U.S. Additionally, emerging markets' balance sheets have been improving relative to those of the developed world and, as such, credit ratings in the developing world are stable. Generally, when a bond's credit rating improves, the value of the bond climbs and its yield falls. So, while U.S. interest rates may increase in the future, many emerging market bond yields are positioned to decline, providing a much higher return.

There are a number of alternative investment strategies that provide yield including, but not limited to, real estate investment trusts, limited partnerships, market neutral strategies, and inflation hedges. In addition to enhancing a portfolio's yield, alternative investments are not highly correlated with traditional asset class returns and therefore can reduce a portfolio's overall volatility. As many alternative investment vehicles lack liquidity, they are not suitable for all portfolios. The only alternative investments we consider are real estate investment trusts, master limited partnerships, commodities, and inflation hedges.

Although risks remain, including the upcoming U.S. budget debate and federal debt ceiling deadline, we feel investors and markets have discounted more bad news than good in the current economic and market outlooks. Any resolution to the fiscal cliff will lift both consumer and business sentiment, which should release pent-up demand that may offset any

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fiscal drag in 2013. The benefits from cheaper energy as well as expansions in autos and housing (traditionally early cycle contributors to economic growth) could propel the economy more than presently anticipated in 2013.

As has been our position for some time, we continue to favor, on balance, equities over bonds in client portfolios. A reduction in economic and policy uncertainties may pave the way for improved confidence and expansion in stock market multiples even as the earnings growth rate, projected to be 5%, remains moderate for both 2013 and 2014 (FactSet). Given our outlook, we continue to overweight stocks within our asset allocations. Further, as correlations across equity markets around the world have declined, portfolio diversification has slowly regained its ability to reduce risk while adding returns. (2011 Institutional Advisory Services Group, Inc. [article/alternative investments](#).) We therefore are diversifying within our equity allocation by increasing our exposure to global companies. Our preference is for geographic regions with above average-growth or compelling valuations such as Latin America, emerging Asia, and Europe.

The Federal Reserve has stated that it will not increase interest rates until the unemployment rate is reduced to 6.5%. Although unemployment will improve as the housing and auto industries expand (both are labor intensive), it will take most of 2013, if not longer, for the unemployment rate to reach the Federal Reserve's target. Short term interest rates therefore will likely remain unchanged in 2013, while the level of longer-dated rates will be dictated by the inflation outlook as well as supply and demand imbalances. In this environment, we maintain an overweight to high-yield and corporate bonds and limited exposure to "safe havens" such as Treasury and Agency bonds.

All in all we are sanguine about capital market returns for 2013. Most of the market's headwinds have been well discounted and therefore surprises should come on the positive side; potentially providing long-term investors better returns than presently anticipated.

Cambridge TrustLetter

Winter 2013

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