Economic Outlook
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- The concern I have about the fiscal cliff is not that politicians will stumble over it, but rather that the private sector will stop and watch. We could see a resolution to the cliff in the first quarter, but see employment growth go to zero in the interim.

- ConvergEx Group, on the US fiscal cliff

- The idiocy of triggering a self-induced debt crisis and economic slowdown is so clear that an outbreak of common sense is likely at some point.

- Societe Generale on the US fiscal cliff

- Ordinary people like us all know the Emperor has no clothes. The Emperor himself knows he is naked. He also knows that we know. And yet he still walked out like this.

- China Reform magazine on China Communist leaders at the recent Party Congress

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As the end of 2012 approaches, the US economy is still struggling to find its feet after the Great Recession of 2007-09. Unemployment remains elevated at 7.9% while GDP is growing at a modest pace of around 2%. The recovery continues at a rate that is well under this point in the recovery in previous cycles. It could be argued that this would be expected following a credit-induced recession like that which just ended because this type of recession normally takes roughly twice as long as a more typical inventory- or commodity-related down cycle. And the recent recession was arguably more extreme than almost any preceding occurrence.

However, recent economic readings from the US have been encouraging. Most notably, the housing industry has moved smartly off its nadir of over a year ago. Existing home sales for October, 2012 were at a 4.79 million rate while prices were up 11.1 % from a year ago, extending the string of monthly annual increases to over a year. October's gain was the largest since November, 2005. The low in existing home sales was an annual rate of 3.39 million in July of 2010. The number of homes on the market fell to a 5.4 month supply, the lowest since February, 2006. While housing certainly has put in a substantial recovery from the lows, the annual rate is still far below the peak in annual sales of 7.25 million in September of 2005 at the peak of the housing craze. But since the 2005 level was so extreme and did not reflect true ongoing housing demand but rather hysteria and ludicrously slack lending terms, comparisons with today's run-rate are misleading. A healthy rate in the current economy is probably around 5 – 5.5 million.

It is also true that there are some caveats to these figures. There is still a large backlog of foreclosed homes waiting to be processed by banks as well as many homes that have been held off the market and will return with prices improving. Credit standards are still on the tight side coming off the housing debacle of a few years ago and many individuals burned in last decade's housing crash are still reluctant to return as owners, finding renting to be a comfortable alternative. While some complain that higher lending standards are hindering the housing expansion (including recently the Chairman of the Federal Reserve), they are definitely a positive for healthy growth over the longer run. After all, if more sensible borrowing requirements had been in place in the mid-2000s, we wouldn't have to be recovering today. Still, the gains in housing have been impressive and IF they can be maintained with no fiscal cliff or recession ahead, that sector will have been a solid underpinning for the US economy.

The improvement in housing is a big boost for the US economy. Not only does it lead to meaningful additional employment gains in the lower income sector which have been hit hardest by the recession but also has substantial follow-on effects on many other industries. For example, sales of pick-up trucks and vans used by most contractors and tradesmen have risen briskly and receipts at home improvement stores and home suppliers are strong. The rise in home prices helps to repair consumer balance sheets by allowing more people to refinance their older, higher rate mortgages, which, in turn, frees up income which can be saved or spent. Many people who are refinancing or selling homes are requesting "cash-in" mortgages where the mortgage balance is reduced and/or the final maturity shortened, lowering total financing costs.

Consumer spending has held up well considering the difficulty for many in finding a job following the layoffs during the last recession. Another headwind for consumers is the fact the average hourly earnings (AHE) have not been increasing, doubtless due to the large number of unemployed seeking work and the sputtering growth in the economy. AHE are at the same level as a year earlier and are *lower* than the beginning of 2009. Consumer confidence is also rising slowly but still well below readings registered in a normal expansion. The need for delevering the consumer balance sheet by definition requires a larger portion of disposable income to service debt and, thus, reduces the spendable portion. It is expected that this process will persist for at least another 3-4 years. In spite of these forces, consumer spending is growing at a rate of about 2-3 % per year. Car and light truck sales have been robust due to the record-high average vehicle age and improving confidence. As in housing, the outlook here is mildly positive IF another recession can be avoided.

The weaker areas of the economy have been exports, capital spending and government. It shouldn't be surprising that capital spending has slowed in that 1) it was the sector that led the economy out of the recession with strong growth which couldn't last indefinitely and 2) uncertainty stemming from the fiscal cliff and how it will be resolved as well as many unknowns relating to the costs and structure of the new healthcare laws. And of course if the US does in fact go over the cliff like Thelma and Louise, a recession will begin immediately and obviate the need for adding new equipment, buildings and technology, not to mention new workers. Exports have trended down for several months, not only those of the US but many other countries as well, due to falling demand from Europe and a notable slowdown in China. Hopefully more recent stronger reports from China will be sustained and at least partially offset weakness elsewhere. The government sector has been shedding jobs and cutting spending at all levels – federal, state and local, and is expected to do so in the future. The normal role of government in stimulating the economy in a recessionary period is thus negated which also contributes to the disappointing pace of the recovery.

Hurricane Sandy will likely cause distortions in economic statistics over the next 3-4 months making tracking the economy difficult. Work hours have been lost and jobs in some cases. Property damage will likely be the highest of any major storm except Katrina. Much of the aging infrastructure in the east coast cities will have to be replaced. While nothing will replace the lives, property and personal possessions lost to Sandy, the early weakness from the storm will be recovered to some extent by the ensuing rebuilding process.

Looking ahead, the tenor of the US economy will be determined in large part by factors beyond the functioning of its fundamental elements. The decisions of the Congress and their timing in regard to the tax code and budget policies will have much to say about how 2013 and later years turn out. To a lesser extent, Fed policy, resolution of European financial and political issues and the stability of the Chinese economy will also play a role.

So much has been written about the fiscal cliff that only summary comments will be provided here.

Firstly, the fiscal cliff is a symptom, not the disease. It is a result of years of feckless policymaking by the US Congress. The cliff is merely the latest in a seemingly endless string of "deadlines" which are never met. Hard decisions have been put off putting the future strength and growth of the US at high risk. The budget deficit and resulting borrowing have stretched the country's financial integrity to the breaking point, led to a bond rating downgrade with another likely to follow shortly and created the present situation whereby resolving the problems will be far more painful than they needed to be had the issues been dealt with earlier. To put a cap on all this, Congress faces yet another debt ceiling late this year.

Secondly, the notion that the economy will be affected starting in the first quarter of 2013 by the combination of spending cuts and tax increases is incorrect: the economy *already has been* negatively impacted. As noted above, capital spending started to decline in the third quarter of this year. Business equipment and software did not increase in the July through September quarter for the first time since coming out of the recession in early 2009. The uncertainty faced by businesses as to government policies, weakening foreign economies and recession fears have frozen business plans.

Thirdly, it is highly unlikely that any sort of meaningful fiscal fix will be reached prior to year end. In all probability, a short term deal will be cut to extend most but not all of the Bush tax cuts and spending authorizations into next year, say, until March or June so the newly elected Congress can weigh in. The current thinking is that by later next year a new plan will be developed to balance the budget over time and to revise the hopelessly complex and inefficient tax code. This process will be harsh, loud and hard to avoid, leading to further uncertainty and negative effects on business and consumers. The choices are now clear – either adopt policies to ease the budget problems which will cause short term pain or extend the current kick-the can-down-the-road to avoid affecting the economy in the short run but open the US to even more severe troubles down the road. Both alternatives are unattractive but the obvious result of chronic irresponsible management. The key conclusion here is that there is no alternative that is painless; as this fact comes further into focus for consumers and business people over the next year, the economic expansion will be negatively affected regardless of which choice is made.

Balancing the federal budget in the future has been made all the more difficult by the current levels of interest rates. The quantitative easing programs of the Fed have brought yields on virtually all types of debt obligations to historic lows. As a result, the total interest cost in the federal budget hasn't changed much over the past several years at the same time that total debt has more than doubled. But this is a time bomb in the sense that, at some point in time, interest rates will rise and the interest paid by the federal government will rise steadily, easily offsetting any earlier steps taken to balance the budget. The Fed's low rate policy in the interest of supporting the economy has lowered the cost of Treasury debt, and thus the budget deficit, enabling Congress to avoid facing (temporarily) the difficult taxing and spending decisions needed.

It is not at all impossible that interest rates can rise in the period ahead.

1. Most market participants accept the Fed's statement that it will keep interest rates low for a specified period of time – the fed funds rate is now pegged at 0-.25%. But the reality is that the Fed controls only short term rates, not those on longer term securities. If rates begin to rise for other reasons (Europe begins to resolve its problems, economic growth picks up or the credit standing of the US declines for example), short term rates could remain low but intermediate and longer rates could rise. Moreover, extraneous factors may convince the Fed to begin to raise its rates sooner than it has indicated (2015) – it did not sign a contract to keep rates low as long as promised. It has only said it intends to keep rates low as long as the economy stays weak *which it anticipates will be into 2015.* Circumstances alter cases.

2. Another misconception is that rates are low only due to the Fed's policy. In fact, a major factor is the continuing problems in Europe and other hotspots around the globe. The emergence of a reasonable plan to resolve the European issues, even over time, would lead to a flight from safe assets such as US, German and Japanese bonds, driving up rates.

3. Yields can't rise unless the economy is booming? Not necessarily. The 1970s experience with stagflation proved that poor monetary policy, supply shortages and escalating commodity costs can lead to a rising general price level and high interest rates. With the Fed and all the other major central banks pumping reserves into the global economy on a scale never before seen, it remains to be seen what the inflationary implications will be.

4. No one knows when or how the Fed and other central banks will withdraw the massive stimulus it's provided. But when it does, rates will rise. And the mere hint that the Fed could be moving away from its wide open easing stance would lead markets to price in yield increases long before the Fed finally acts.

The point in these comments is not that interest rates will necessarily rise soon, just that at some point they can and will. And with the incredible amount of debt outstanding and most, if not all, major countries' financial circumstances in dire straits, a rise in interest rates would carry serious risks. Granted, that after living in a zero rate world for some time, it seems as though rates will never increase. But our responsibility at Brookfield Investment Partners is to be looking ahead and attempting to grasp what conditions really are on the ground, as it were, regardless of whether we like them or not. Only then can effective investment decisions be made.