Pinnacle Capital Management, LLC

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COMMENTARY

Watch Out For The Cliff!...Oh never mind

ECONOMIC STATISTICS	4th Qtr (12/31/13)	3rd Qtr (9/30/13)	% Change	1 Yr Ago (12/31/13)	% Change
S&P 500 Index	1,848.36	1,681.55	*9.9%*	1,426.19	*29.6%*
10 Year Treasury Yield	3.02%	2.61%		1.76%	
Gold Spot ($ / oz)	$1,205.65	$1,328.94	*-9.3%*	$1,675.35	*-28.0%*
WTI Crude Oil (next future)	$98.42	$102.33	*-3.8%*	$91.82	*7.2%*
GDP Qtr / Qtr	N/A	4.1%		0.1%	
CPI Y / Y	1.5%	1.2%		1.7%	
Unemployment Rate	6.7%	7.2%		7.9%	

Illusionists and politicians have something very much in common. They have the ability to distract their audiences via a slight of the hand to prevent their audiences from noticing what is really going on. The difference between the two groups is that illusionists are usually much better skilled. So as 2012 wound down with the nation careening towards the fiscal cliff, many investors took their collective eyes off the ball and failed to take heed of the underlying picture. While the collective gaze was focused on Washington, the obvious was concealed in plain sight: the U.S. and global economy were growing with few real excesses, interest rates were extremely low, and equity valuations were still subdued despite price gains since 2009.

As 2012 faded and 2013 progressed, Washington continued to distract. Debt ceilings, government shutdowns, ObamaCare, etc. all served to obscure what really counts. Just as the illusionist causes his audience to gasp when the assistant appears in what was thought to be an empty box, the Washington foibles left few prepared for market returns in 2013 – an approximately 30% gain in the equity averages accompanied by a modest decline in bond prices. And while we in no way predicted such a roaring bull market, based on the underlying facts explained above we urged our investors to maintain investments toward the upper end of their equity tolerances and likewise towards the lower end of their fixed income tolerances.

So you ask, "What again was that fiscal cliff?" Most recall it was something scary that drove their investment decisions. Few remember what it was actually all about. If you do remember we congratulate you. In truth, even we had to consult the World Wide Web in order to refresh ourselves as to the details. In a nutshell, the fiscal cliff dealt with two events simultaneously coming to pass on December 31, 2012: the expiry of the Bush tax cuts and the implementation of automatic cuts to the Federal budget ("sequestration"). As of today, sequestration remains in place; tax cuts were partially reversed for upper income taxpayers and extended for others. There were certainly issues to be addressed, but was this really our definition of a "cliff"? Why were we so concerned? The answer is simple. We were drawn into the drama. Our retort is also simple. Drama is fine for the stage, TV, and movie screen. It has so place in investing.

Of course we've only dealt with the fiscal cliff in this Commentary. We haven't covered the other government crises. And we feel no need to do so. The gamesmanship of Washington is like a big merry-go-round. We as investors need merely to accept that the conditions to perpetuate this will continue to exist for the near future. But this side show is just that, and we'll treat it as such by ignoring what we can.

What about the outlook for 2014? We're actually quite encouraged. First, we believe the global economic up cycle may be quite prolonged. Ironically, this is largely because growth has been so tepid. As a result of the modest economic growth, tightness in bank lending, and general skittishness by business people and investors, the usual threats to global growth seem quite muted. This doesn't mean that there aren't risks. If there is one place we see excesses, it is in the government sector. Spending is still way too high while interest rates are still too low. We believe that the U.S. and world economy can survive rising rates – especially at the long end – but we're certainly going to keep our eyes on both the magnitude and extent of such increases. We're also aware that because growth is still on the modest side, an unexpected shock, such as a Mideast war, could have severe repercussions.

We maintain our outlook for continued developing world growth. Latin American growth has certainly slowed, though we do expect reacceleration. Still, the situation bears watching. In any case, we believe the bulk of developing world growth will be reflected in increases in the consumer side. Manufacturing will do all right, but we will not likely witness the great advances we've seen in the past driven by exports to the developed world. One nation that's recently caught our attention is Mexico. We're particularly impressed with reforms we're seeing in that country. We wouldn't be surprised to see some manufacturing actually shift from China to that country.

Our outlook for the U.S. hasn't changed much. We've said for some time that the U.S. simply must produce more than it consumes. As a result, the manufacturing and export sectors should see greater growth than the consumer and import sectors. It also may surprise many, but government spending growth should be fairly modest even if overall levels are still quite high. There just are neither the dollars nor the political will to accelerate government growth.

One sector that bears mentioning is healthcare. This sector of the U.S. economy is facing incredible uncertainties. We'll risk some political backlash from our readers by stating that the economics of ObamaCare simply don't work. If ObamaCare were merely a first step toward nationalized / single payer health insurance, we could see a path as to where all of this was going. Yet because of all the difficulties to date, we doubt there exists much political will for advancing the idea that government should take on an even a bigger role. On the other side of the coin, we also don't see a high likelihood for repeal of ObamaCare. As such, we're stuck in no-man's land. We forecast higher insurance rates and lower spending on big ticket items. There will also be reduced appetite by companies for spending on health care innovation.

Finally, a few words about equity and fixed income markets. Equity valuations are still quite reasonable. But they aren't dirt cheap as they had been the past several years. We don't expect another 30% up year, and markets could even be down. Nonetheless, we still believe the equity markets are where we want to be. We're still bearish on the bond markets. The year closed with the 10 year Treasury rate at 3%. We wouldn't be surprised if rates continued to rise, leaving bond prices lower at year end 2014 than year end 2013. Overall, the choices are getting tougher. The wind is still at our back, but it's going to take some careful steering to get us where we want to go.