THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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Threat of a fiscal cliff dive is diminishing. Economic growth likely to be markedly stronger in 2013.

We have argued since the summer that the economy is able, ready and willing to pick up speed. The fundamentals are all flashing green.

Look at some key barometers on the economy's health.

- Banks are much better capitalized (both in terms of quantity and quality of capital) and have begun to ramp up lending.

- Households have completed their deleveraging. The combination of record low interest rates and declining debt has reduced their debt service burden to the lowest in 18 years. Consumers are in a shopping mood again.

- The two crucial sectors that typically lead an economy, autos and housing, are resuming their role. There has been a sustained upswing in sales for both.

- While companies have seen their earnings sag recently because of the global economic slowdown, they have nevertheless amassed a near record $1.7 trillion in cash reserves by cutting operating costs and expanding margins. This is capital ready to be put to use. **All that is needed is more clarity on the economic outlook.**

So we ask the next obvious question.

Are business leaders, consumers, and investors gaining any more clarity on how the economy will perform in 2013?

Here we have to make a distinction between clarity and confidence. As for clarity, the answer can be summed up with a soft "not just yet." Who can blame them for being hyper cautious when there is still ubiquitous talk of driving off the fiscal cliff?

Yet, in spite of their caution, there is an emerging optimism that after Nov. 6, more adults will ***finally*** enter the room in Washington and seek not only to avert a disastrous fiscal cliff scenario but to work more earnestly on a framework that would lead to an Omnibus deficit reduction agreement next year.

Is this optimism warranted?

We believe it is. First, secret meetings are currently underway at Mt. Vernon by a "gang of eight" Senate leaders --- four Republicans and four Democrats --- who are working on a framework that will cut entitlement spending and raise tax revenues. You won't hear President Obama or Governor Romney publicly refer to these talks, and that is a good thing. But work is quietly taking place behind closed doors to avert a fiscal cliff plunge and recession next year. Let's face it. In the final analysis, no reasonable politician would want to have blood on his or her hands for triggering the next recession. Economic downturns typically have occurred after a major spike in oil prices, or when the Fed inadvertently over tightens monetary policy. But that's not what is at stake here.

A Washington-induced "fiscal cliff" recession would be unprecedented in American history. The notion that a paralytic Congress knowingly sabotages an economic recovery and worsens unemployment is unfathomable to most Americans (i.e., voters). We suspect few politicians would be comfortable owning such a legacy. What's more, everyone knows a fiscal cliff recession is, in fact, shockingly easy to prevent.

We believe that once the election is over, some modicum of reason and bi-partisanship will return to the nation's capital. As the probability a fiscal cliff recession declines, both the economy and the financial markets will simultaneously show their approval.

To some extent, we have already seen private sector confidence about the future firming. Homebuilder optimism surged to its highest level in six years in October! And in a separate survey by the National Federal of Independent Business, the percentage of small businesses in September who believe "the outlook for general business conditions" will get better in the next six months jumped to the highest in more than a year!

OUTLOOK FOR GENERAL BUSINESS CONDITIONS

Net Percent ("Better" Minus "Worse") Six Months From Now

(Seasonally Adjusted)

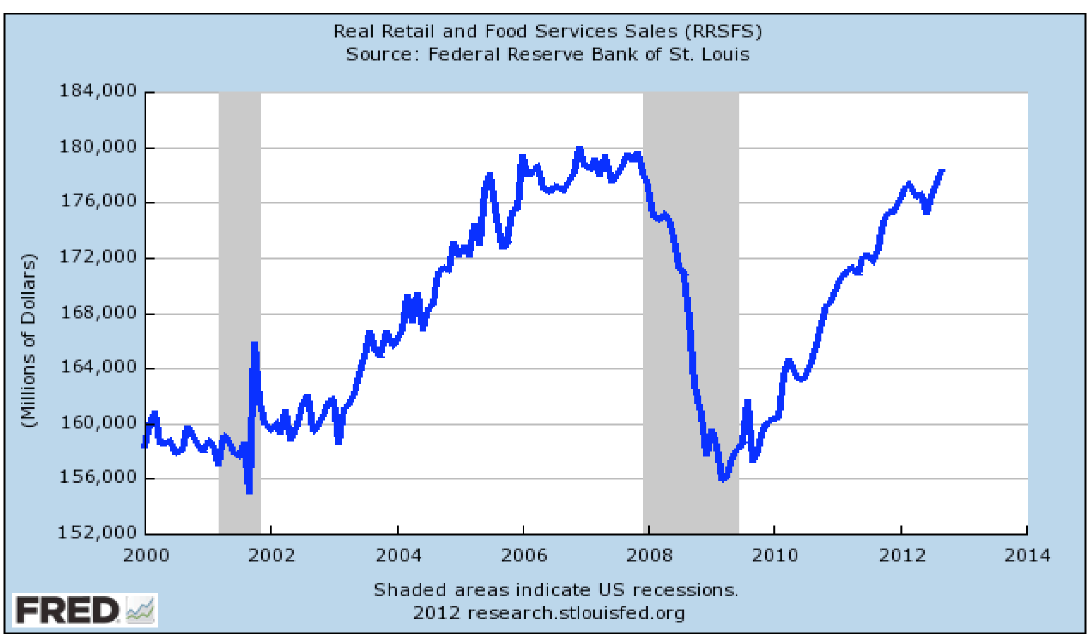
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2007	-1	-2	-7	-8	-3	-5	-1	0	2	-2	-10	-10
2008	-22	-9	-23	-12	-12	-19	-17	4	14	-4	-2	-13
2009	-12	-21	-22	2	12	7	-3	10	8	11	3	2
2010	1	-9	-8	0	8	-6	-15	-8	-3	8	16	9
2011	10	9	-5	-8	-5	-11	-15	-26	-22	-16	-12	-8
2012	-3	-6	-8	-5	-2	-10	-8	-2	2			

Source: National Federation of Independent Business

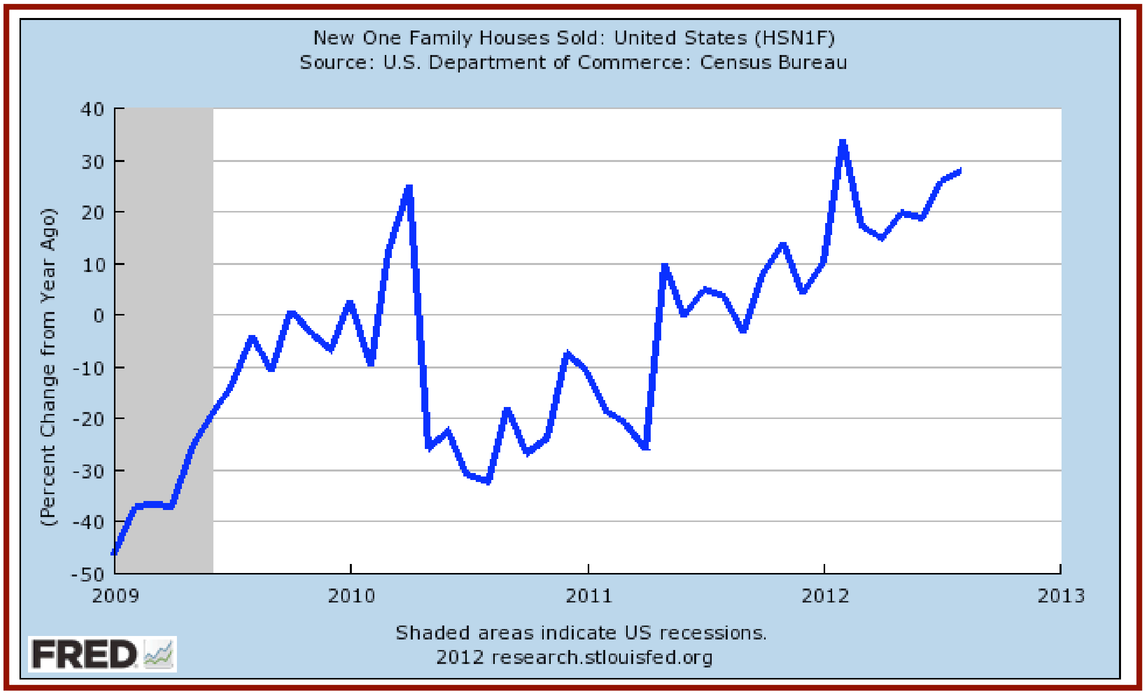
What about consumers, the main drivers of the economy? The University of Michigan's survey on consumer sentiment just shot up to a 5-year high mid-October. The weekly poll by Bloomberg also detected a rebound as well, with their latest Consumer Comfort Index climbing to its highest in six months.

Has this improvement in consumer spirits translated into more spending? It appears so.

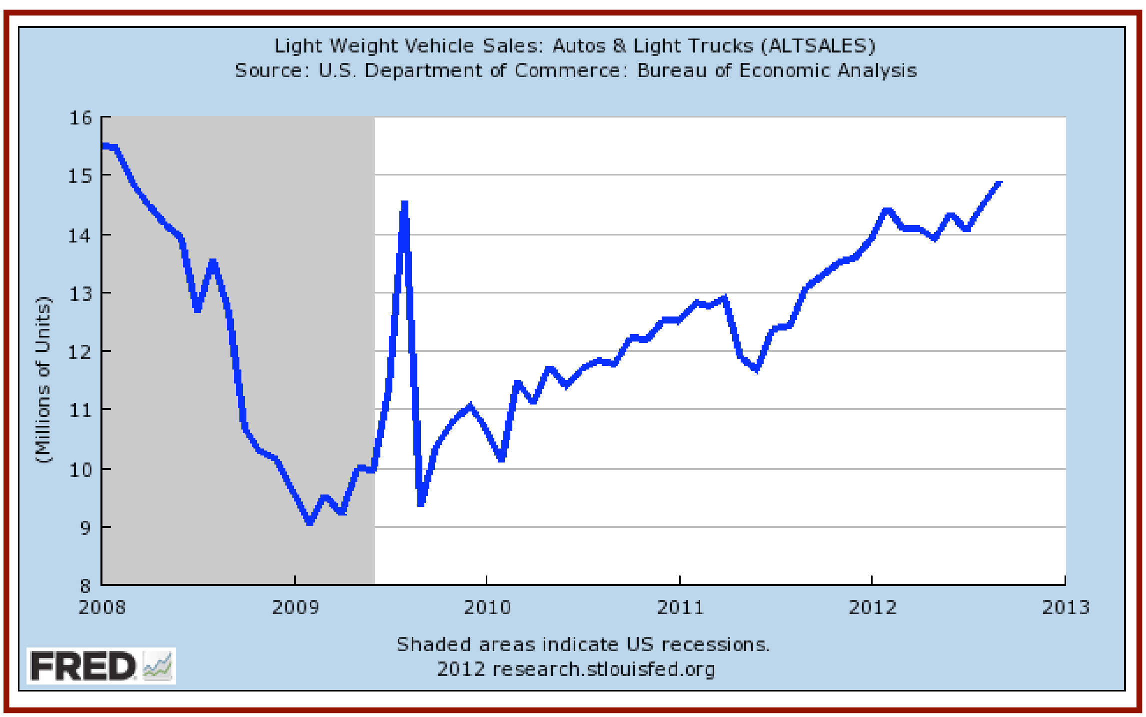
• Retail sales in August and September marked the best two-month gains in two years



• New and existing home sales are up by double digits percentages over the past year. (Sales have climbed 11% for existing homes and 28% for new homes).



• Automotive purchases last month leaped to a 14.9 million annual rate, the best since March 2008.



Another business indicator we follow closely is the Cass Freight Index, which looks at the supply chain sector. This is the economy's circulatory system that delivers commodities and finished goods to retailers, wholesalers, and manufacturers around the country. Have such shipments picked up? Absolutely. The Cass Freight Index (which quantifies the volume of products transported in a particular month) rose in September to the highest in a year.

If you add to that the latest increase in "new orders" from the ISM's manufacturing and service surveys, there is a clear sense the economy is in the process of transitioning toward faster growth.

These signs have not gone unnoticed by equity investors. Remember, changes in growth expectations and earnings are key drivers in stock prices. They influence demand for equities and P/E multiples. Had there been a perception that a fiscal cliff recession was nearing, the S&P 500 index would not have returned 6.4% in the third quarter, more than 16% year to date --- and it certainly would not have encouraged stock prices to rise even further so far this month.

Bottom line:

The positives are building: (1) We believe the threat of a fiscal cliff dive is diminishing; (2) The bitterly fought and divisive presidential campaign is about to close and that should advance more bi-partisanship in Congress; (3) The Eurozone has stepped back from its own financial precipice and is (albeit slowly) on track to resolve the crisis; (4) China's new leadership will likely utilize more fiscal and monetary tools in the coming months to forestall a serious economic slowdown; (5) Significant monetary easing by the world's central banks should also help promote growth next year.

All this points to a brighter U.S. and international economic outlook for 2013.

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