FBB capital partners

January 4, 2013

Dear Clients and Friends,

We must accept finite disappointment, but never lose infinite hope.
~ Martin Luther King, Jr.

There is a false notion in the popular news media that the so-called **fiscal cliff** was averted after last-minute negotiations between Congress and the President. In truth, the United States did indeed go over the fiscal cliff, but *so far* the impact appears less damaging than it could have been, largely because the agreed-upon $650 billion in tax hikes is far less burdensome than the revenue levels targeted in earlier discussions.

However, the expected contentious wrangling over budgetary spending cuts was simply delayed for two months. What's worse now is those negotiations will coincide with yet another heated debate about raising the US **debt ceiling**. Remember the last time Congress had that fight? The financial markets were in turmoil over the possibility of a Treasury debt default, and the US lost its AAA credit rating. We anticipate a bumpy ride this time too, though we remain hopeful that any market dislocations will prove short lived.

There is a lot of misunderstanding of what the debt ceiling represents. It is *not* a limit on government spending. It is simply a constraint on the US Treasury's ability to issue new debt to cover spending that has already been authorized by Congress and the President. As Politico's Ben White summarized, "Congress blocking a debt limit increase is akin to someone running up a credit card bill and then refusing to pay the bill in order to control spending. It makes no sense, but logic rarely intrudes on dangerous Washington political fights."

Assuming a rational resolution to the debt ceiling issue and reasonable spending reductions, we expect a post-cliff fiscal drag of around 1% to 1.5% of GDP in 2013, which should still allow for **modest economic expansion.** In other words, we expect more of the same "slow and low" growth we've been discussing for some time, though perhaps at slower and lower levels than before.

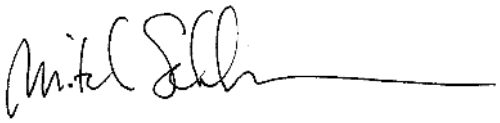
Even so, **interest rates could finally drift slightly higher this year**, as several Fed members have suggested an end to the Fed's "quantitative easing" program may be close at hand. The Fed's efforts have pushed rates to artificially low levels, so an eventual return to more normalized levels should not only be expected but also welcomed, as we have seen fewer and fewer attractive bond offerings in recent years. That said, we still do not expect a dramatic rise in rates, as the economy is yet too fragile and the government would not appreciate the jump in its interest bill. Also, our trading partners who regularly buy US debt with their reserve currency holdings (e.g., China) might take issue with a sudden drop in bond values.

We do expect corporations to rein in Wall Street's rosy earnings forecasts for the New Year, just as we did at the start of 2012. Dividend stocks, which were last year's laggards, should be back in favor now that tax-related uncertainty is behind us. However, we expect **cash flow growth** to be a dominant factor for equities in future periods, with or without accompanying dividends. Cash flow growth can translate into share buybacks, accretive acquisitions, or at the very least, internally funded expansion without the need to borrow. Companies with declining cash flow or who lower their dividends will likely be dealt with harshly, and we have already culled some holdings where we foresee cash flow shortfalls, and will continue to do so as necessary.

We also anticipate renewed interest in international investing arenas, as Europe appears to have gotten past its own financial crisis and China seems to have successfully avoided a hard economic landing. The emerging economies, many of which now have healthier balance sheets than the large developed nations, look particularly attractive over the long haul.

And last, we remain optimistic about the ongoing recovery in the US housing market, which we began highlighting early last year. If mortgage financing rates remain attractive, as they should, then the housing recovery should continue apace, helping to offset some of the anticipated drag from the fiscal cliff negotiations.

With best wishes for the New Year,



Mitch Schlesinger
FBB Capital Partners

P.S. We update our news "blog" several times each week with selected articles on economics, investing, and financial planning. You can see it at http://www.scoop.it/t/fbbcapitalpartners. Or to make accessing the articles even easier, you can follow us on Twitter, where our name is @FBBCap. The blog updates are automatically posted to our Twitter account – you can even have them sent to your smartphone!