GREENWOOD REPORT

pol · i · tics

\ˈpä-lə-ˌtiks\

Origin:
poly – *Greek* for "many"
ticks – *English* for "blood sucking parasites"

With apologies to the great public servants of our nation and state (some of whom are friends of Greenwood Gearhart Inc.) we open this report with the above tongue-in-cheek joke told last week by Former Senator Alan K. Simpson of Wyoming at the 2012 Schwab IMPACT conference. IMPACT, held this year in Chicago, is an annual gathering of approximately 1,700 Registered Investment Advisers like Greenwood Gearhart Inc. from all over the country. The commonality amongst these advisers is that they are all institutional clients of Schwab Advisor Services, the industry-leading provider of custody and clearing services for clients of independent investment firms. If you happened to watch CNBC last week, you may have noticed that IMPACT was the backdrop for many of their top programs. (Hopefully you weren't watching too much CNBC as the pervasive negativity in their programming clouds one's judgment!)

Politics dominated our conversations with other industry participants at the conference. Alan Simpson (Republican) and Erskine Bowles (Democrat and former White House Chief of Staff) were two of the speakers in an impressive slate of political leaders, economists, investors, and great "thinkers". Together, Simpson and Bowles were the chairs of the National Commission on Fiscal Responsibility and Reform, a Presidential Commission created in 2010 by President Obama to address the looming "fiscal cliff" and other issues critical to our economic prosperity. The term "fiscal cliff", now firmly part of our lexicon, has captured the news headlines since the election. While the Simpson and Bowles proposal was ultimately unsuccessful in creating a solution that bridged both parties, their work is being used as a general framework for negotiations.

The "fiscal cliff", refers to: the expiration of the Bush tax cuts (extended by Obama in 2010); the across the board spending cuts or "sequestration" as required by the Budget Control Act of 2011; the reversion of the Alternative Minimum Tax thresholds to 2000 tax year levels; the expiration of the Medicare "doc fix"; the expiration of the 2% Social Security payroll tax cut; the expiration of the extended federal unemployment benefits; and the new taxes imposed by health care reform. It is, in many ways, the perfect storm of economic change. Each piece of the "fiscal cliff" would, in normal economic times, be considered "hot-button" issues for both parties. Given the common date of their enactment/expiration (January 1) and the current, sluggish economic environment, the potential market

impact of the collective issues is immense. Regardless of party affiliation, most politicians agree that going over the "fiscal cliff" could threaten to derail an already fragile economic recovery. If nothing is done, the non-partisan Congressional Budget Office (CBO) estimates a drop of 0.5% in real gross domestic product (the income of the United States, after inflation), a rise in unemployment to 9.1%, and another recession by the end of 2013. By contrast, if the cliff were averted all together, real GDP could be 2.2% higher and 2.7 million jobs could be created. **The cliff is steep, the chasm between parties requires a vast bridge, and our nation's leaders have only fifteen working days to craft a solution!**

Not surprisingly, our number one client question since the election has been "what is going to happen with the fiscal cliff?" Unfortunately, much to the chagrin of our clients, we do not have a certain answer. Like every short-term issue in investing, there is uncertainty about the short-term impact to client portfolios if we "go over the cliff." One can, however, assign probabilities, and we see three possible scenarios, with scenario 2, in our opinion, carrying the highest probability.

Scenario 1: No deal is reached, all of the aforementioned changes/reversions take place at once, and we go over the fiscal cliff. Like 2011, the credit agencies inject themselves, the market gets "angry" and signals to Washington that something must be done. It is important to note however, that a solution is possible and **this does not have to happen**!

Scenario 2: Congress comes back from the Thanksgiving holiday, works through mid-December and reaches a partial deal either right before Christmas or the New Year. This partial deal is enough to calm the markets, but **is akin to "kicking the can" down the road** to next year.

Scenario 3: A Grand Bargain is reached, whereby the Republicans agree to raise revenues and the Democrats agree to reform the social programs. While a long-shot given the time constraints, there are rumblings that Obama, in an effort to prove himself as a negotiator (a major criticism from his first term) and John Boehner, in a position of weakness after the election, may come together to lead their parties to a solution. Consensus seems to focus on the fact that higher taxes **and** reform to Social Security and Medicare will be required to restore our nation's financial health.

In our opinion, the worst case (scenario 1) will be averted. However, as we get closer and closer to January 1st without a solution, the markets may exhibit greater volatility.

Regardless of the timing of the solution, the fundamentals of the economy continue to improve. The short-term impact of the fiscal cliff could be very real, but ultimately we have reason to continue our optimism for the long-term health of the corporate, household, and government sectors and, as a byproduct, the stock market. The temporary impact should not be enough to disrupt the long-term trends of the recovery:

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1. Recent reports from the Energy Information Adminstration (EIA) indicate the United States is moving towards energy independence.
2. Businesses are still holding record amounts of cash on their balance sheets, a future catalyst for growth.
3. The consumer is alive, has deleveraged, and stress levels have eased significantly.
4. Corporations are reporting record profits.
5. Inflation remains low.
6. Unemployment and jobless claims are falling.
7. Monetary policy is accommodative and interest rates are at all-time lows, providing a low cost of capital.
8. Housing starts are rising, inventories are low, home prices are appreciating, and optimism among home builders is up.
9. Money continues to flow into bond funds at the expense of equities, a trend poised for eventual reversal.
10. The exponential growth in technology signals a *future that is better than you think.*

"The Future is Better Than You Think"
- Peter Diamandis

Another highlight from the IMPACT conference was a talk given by Peter Diamandis. Diamandis is a futurist and he is an optimist. He and his business partner, Ray Kurzweil, co-founded Singularity University; an interdisciplinary university whose mission is to assemble, educate, and inspire a cadre of leaders who strive to understand and facilitate the development of exponentially advancing technologies to address humanity's grand challenges. As Diamandis describes in his New York Times bestseller *"Abundance: The Future Is Better Than You Think"*, the world is accelerating at an exponential rate. By exponential, he refers to the difference between taking thirty linear steps and thirty exponential steps. If a human travels thirty linear steps, he ends up about thirty yards away from his starting point. If he travels thirty exponential steps (1, 2, 4, 8, 16, 32, 64, 128, etc.) he has traveled around the circumference of the earth twenty-six times!

Research shows that the human brain is wired to think linearly and locally (thirty yards) not exponentially and globally (26x the earth's circumference). We also overwhelmingly tend to focus on negative news (the news media knows this) as opposed to positive news. This traces back to our most primitive days as hunters and gatherers, when mere survival was paramount. For thousands of years, humans coalesced in relatively small regional clusters. Generation after generation lived on the same plot of land. One generation's way of life was virtually identical to the preceding generation; that is until the 20th century. As our economy progressed from agricultural based, to manufacturing based, to service based, and now digital / data based, we have experienced exponential growth in technology and thus, our quality of life. This exponential growth is perhaps best described by the semiconductor industry and specifically, Moore's Law. In 1965, Intel co-founder Gordon E. Moore, observed that over the history of computing, the number of transistors on integrated circuits doubles approximately every two years. Moore predicted this trend would continue "for at least ten years". Instead, it continued much longer (over the next half century) and is still used in the semiconductor industry to guide long-term planning and set targets for research and development. It is the primary reason that every two years your "new" $1,000 computer is largely obsolete!

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Moore's law informs the thinking of Diamandis and Kurzweil. By identifying technologies that follow an exponential growth path, Kurzweil has been uncannily accurate with predictions ranging from the explosion of the internet, IBM's Deep Blue computer's defeat of chess champion Garry Kasparov, and most recently, the simulation of "protein folding". Their predictions for the next decade are astounding and have major implications for investment, our economy, and global quality of life. The ideas of today will be realized tomorrow, another three billion people will be connected to the internet, and computers will be able to think at the speed of the human brain, all in the next decade. The amount of data we are generating will produce new information that will feed new technologies and solve some of the world's most vexing problems. To illustrate, from the beginning of time through 2003, there was five exabytes (think of five billion jump drives) of data created in the world. In 2010, we created five exabytes in two days. By 2013, we will create five exabytes every 10 minutes. Big Data is here and those who can use it to create new, useful information will thrive in the digital age.

What does all this wide-eyed scientific thinking mean for investors? The possibilities are endless. With a global view, we as investment advisers can be better equipped to capitalize on trends associated with globalization and the digital revolution. Though we do not predict the future, we do use the research of individuals like Kurzweil and Diamandis to inform our investment decisions. We own corporations based on underlying company fundamentals, preferring a bottom-up analysis of their financial statements. But the top-down, macro view often provides the environment for the long-term success of the companies we own.

Further, this research reinforces our optimistic view of the world. Some call us Pollyanna. But they don't see the hours of research we put into each investment decision, much of our research focusing on stressing a company for adverse scenarios. While we are optimistic by nature, we do not turn a blind eye to the problems facing the world. As investors, it is our job to worry so our clients don't have too. Still, some perspective is important: we are living in the most dynamic and exciting time in the history of the world and our problems, no matter how complex, are solvable. Once we get past the fiscal cliff, a new problem will emerge. And when we solve that, another will be waiting. **But the future is better than you think.**

We encourage you to contact us if you would like to discuss your individual portfolio in further detail. We want to hear from you and certainly expect you to have questions. We wish all of our clients and friends a Happy Thanksgiving.

G. Brock Gearhart, CFA
Mary Ann Greenwood, Ph.D., CFA

November 21, 2012

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