ANNUAL FORECAST ISSUE

Kiplinger's

2013

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OUTLOOK 2013

Despite a long list of uncertainties, stocks will once again beat bonds and cash.»

BY ANNE KATES SMITH

CALL IT THE BULL MARKET THAT EVERYONE LOVES TO HATE. DISSED BY PROFESSIONALS and deserted by individual investors, the U.S. stock market climbed the proverbial wall of worry in 2012, despite a climate of economic unrest and enough political uncertainty to give any sane investor pause. "Bleak is the new black," quips Larry Hughes, chief executive of BNY Mellon Wealth Management, who says he's never seen market sentiment so negative.

And yet, stocks have beaten—by far—asset classes more beloved by investors. Over the past year through November 7—the period since we published our last annual outlook story—Standard & Poor's 500-stock index returned 13.2%. The U.S. bond market returned 4.8%, and cash pretty much earned nothing. Now, with the economy still sputtering, corporate earnings faltering and sales at many companies sinking, it's fair to ask: Can the stealth rally continue? Or will the stock market finally succumb to its poor reputation in 2013?

We think investors should hold their noses and stick with stocks. Patient investors can pick up bargains during periods of weakness—of which there could be plenty in early 2013, when things will likely be messy in Washington and on Wall Street. But with economic disaster averted overseas, and as the clouds of fiscal uncertainty at home begin to part later in the year, we think that corporate profits can continue to grow modestly on the back of good-enough economic growth. Cash-rich companies that can manufacture growth in a tepid economy will deliver the goods to shareholders.

Bottom line: The market has a good chance of posting gains of 7% over the coming year, with dividends kicking in another two percentage points. That would take the S&P 500 to 1492, while an equivalent gain in the Dow Jones industrial average would take it to 13,838. (To see how we crunch the numbers, check the box at right.) The S&P and Dow closed at 1395 and 12,933, respectively, on November 7.

As we look toward the new year, it's rare—and ironic—that stocks are so disrespected. Investors yanked money out of stock mutual funds and poured it into bond funds throughout 2012. And the so-called smart money doesn't like the market any better. Wall Street strategists haven't been this bearish since Bank of America Merrill Lynch started keeping track in 1985. "Equities are as hated as they've ever been," says Savita Subramanian, Merrill Lynch's chief stock strategist. That suggests, she says, that people are underinvested in stocks and that they've overdone it in bonds. "When investors get their statements for the year and see single-digit gains in bonds and double the returns in stocks, they'll come back to the market."

Despite a rally that has seen the market more than double from its bear-market low in 2009, stocks still represent good value, says Brian Belski, chief investment strategist at BMO Capital Markets. At this stage in bull-market rallies going back to 1970, the S&P 500 is typically 14% higher than its previous peak, he says. But the index recently traded more than 10% below its 2007 high.

Stocks in most market sectors, including consumer staples (companies that make the things we use every day, such as soap and cereal), energy, health care and technology, are trading below their long-term average price-earnings ratios. At the same time, the companies are sporting profit margins and cash levels above their historical norms. Only utilities and telecommunications stocks are trading at above-average P/Es. Belski's bullish conclusion: "We expect the market to hit new highs sometime during 2013."

Now that we know that President Obama will be living in the White House for four more years, you can adjust your portfolio by doing—nothing. Over the long haul, it's nearly impossible to tie a winning or losing market performance to a win for either party, says market analyst Jim Stack, of InvesTech Research.

But a nasty post-election selloff highlighted one gigantic caveat that comes with the benign outlook for stocks and for the economy overall: All bets are off if we get pushed off the fiscal cliff by uncompromising lawmakers in the nation's capital. The cliff refers to about $550 billion to $720 billion (depending on your accounting and what you include in the tally) in spending cuts and tax hikes slated to go into effect at the start of the year. If such extreme and sudden austerity were to occur, the U.S. economy would sink into recession and the stock market could fall 20% to 30%. Stocks sank 2.4% on the day after the

DOW 13,838: HOW WE GET THERE

For our forecasts, we start with the average of strategists' earnings forecasts for the S&P 500. (These "top-down" estimates are usually more conservative than the figures you get by adding analysts' estimates for each company in the index.) In early November, the S&P sold for 13.7 times estimated 2012 profits. We then apply the same P/E to strategists' estimated 2013 earnings of $108.90 per share. That gives us a one-year target for the S&P of 1492, a 7% gain. Add a 2% dividend yield and we get a total return of 9%. Applying the same 7% gain to the Dow Jones industrials puts it at 13,838 in a year. If earnings come in below our figure, our target could be high; if P/Es creep higher, we would be low.

election as investors concluded that ratification of the status quo would make it difficult for lawmakers to agree on a plan to avert the fiscal cliff.

Merrill Lynch economists think that after some messy wrangling, Congress will consent to $325 billion worth of spending cuts and tax hikes. That's enough to lop two percentage points off growth in gross domestic product, they fear, and, depending on the distribution between cuts and tax hikes, could whack the stocks of government contractors and luxury-goods makers. Food for thought: Uncle Sam accounts for 97% of sales at SAIC (symbol SAIC), an information-technology firm.

The fiscal cliff has already been a drag on the economy in the form of an uncertainty penalty, and a neck-and-neck election season didn't help. With so much fiscal, tax and regulatory policy up in the air, corporate boards tilted from cautious to almost paralyzed, letting cash pile up at S&P 500 companies to a $1.7 trillion hoard. Business spending on equipment and software likely grew just 7% in 2012, down from 11% in 2011, says IHS Global Insight. As a plan to resolve our fiscal issues starts to take shape, look for a rebound in economic activity, especially from pent-up corporate spending.

But even the optimists aren't talking about gangbuster growth in 2013. A sluggish first half will combine with an accelerating second half to deliver gross domestic product growth of about 2%—roughly the same rate as in 2012. Housing and vehicle sales will be bright spots, but growth in exports will disappoint, thanks to lingering weakness in Europe and slowing momentum in China. With gasoline prices moderating and wage growth minimal, expect a 2% rise in consumer prices in the coming year, matching the expected 2012 inflation rate. Job growth will continue, pushing the unemployment rate down to 7.5%.

Frustrated savers are unlikely to see higher yields anytime soon. The Federal Reserve has said it will continue to do everything in its power to keep both long-term and short-term interest rates low while the economy remains fragile. Despite historically minuscule rates, income-focused investors can still find good deals in muni bonds and emerging-markets bonds in 2013, as well as in high-yield debt. But bond buyers should be mindful of the risks they're taking in the search for yield. When rates do finally rise, pushing prices down, the blow could be shocking to a whole generation of investors, says Edward Jones market strategist Kate Warne. "We are concerned that investors are underestimating interest-rate risk because they haven't experienced it in 30 years," she says.

Conversely, investors might be more afraid of stocks than they need to be, although given recent deterioration in the corporate earnings picture it's easy to see why people are spooked. The third quarter of 2012 was a dismal one, according to earnings tracker Thomson Reuters, which estimated that profits for S&P 500 companies fell 0.6% compared with the same period a year earlier. That's not much of a drop, but it would be the first decline in 11 quarters. And companies weighing in on prospects for the fourth quarter of 2012 were more pessimistic than they've been since 2001.

Even more worrisome have been reports of falling revenues. Companies have been boosting profits in recent years by cutting costs to the bone and increasing operating efficiencies. "There's very little juice left in that lemon," says Katherine Nixon, chief investment officer for Northern Trust's money-management division (see the interview on the next page). With corporate profit margins at or near peak levels already, where will earnings growth come from if companies can't increase sales? Little wonder that analysts have been furiously revising profit estimates downward for the first half of 2013.

But even if the outlook is less rosy than it was, it's still positive—and perhaps better than things look on the surface. Overall, analysts forecast that S&P 500 earnings will grow 7% in 2013, on top of expected 4% gains in 2012. What's more, says BMO strategist Belski, the quality of earnings is improving, with cash flow (which is difficult to manipulate through accounting tricks) growing faster than reported profits.

As uncertainty gives way to clarity in 2013, things could start looking up for the stock market. Strategist Subramanian thinks investors will be willing to pay more for each dollar of corporate profits—that is, they'll be willing to pay a higher P/E and thus boost share prices overall. "Paralysis in the corporate sector, stymied growth overseas and in the U.S., and uncertainty about corporate earnings—all of that has served to compress P/E multiples," she says. As those trends reverse, she thinks expanding P/Es could help push the S&P 500 to 1600 by the end of 2013.

Even assuming the next market

UPDATE

ON THE MARK WITH OUR MARKET CALL

Our bullish forecast for 2012 was on target, especially considering that we made it at a time of high market volatility and deep disenchantment with Wall Street. We called for stocks to return 9%—but we nearly hit the bull's-eye when we upped our prediction to 15% in the July issue. Over the past year through November 7, Standard & Poor's 500-stock index returned 13%.

Our picks in "6 Stocks for the Year Ahead" weren't as impressive as our market call. Of the six, only Lockheed Martin and Target beat the S&P, returning 22% and 21%, respectively. Microsoft missed beating the market by a whisker, returning 12%. Our worst pick was Schnitzer Steel, which tumbled 38%. Dover made 10%, and Chevron gained 3%.

Ironically, an expanded version of the story that ran on Kiplinger.com (kiplinger.com/links/stocks2012) included our best pick: Apple, which gained 41%. The other Web pick, Teva Pharmaceuticals, fell 1%.

cycle is a bullish one, it might be very different from what investors are used to. The Fed can't ease rates much more than it has already, the government is likely to turn from spending to austerity, and consumers who once spent frenetically will probably keep their belts relatively tight. The great deleveraging, as Subramanian calls it, will favor large, cash-rich companies that aren't dependent on credit to grow and that can deploy their cash in creative ways—by buying other firms, for example, or returning cash to shareholders via stock buybacks or dividends.

The technology sector is the poster child for the structural change taking place in corporate America. Tech companies have consolidated manufacturing capacity, they carry little debt, and their profits have become less tied to the economy. Plus, tech is now one of the top dividend-paying sectors. One of our favorite stocks is **QUALCOMM (QCOM, $58)**, which supplies the chips used in many smart phones.

Investors will have to be more selective in 2013. In a lackluster economy and a climate of uncertain earnings growth, look for companies that can chart their own course, says Warne, of Edward Jones. That means companies entering new markets, launching new products or devising a new or unique business strategy. Edward Jones suggests ketchup king **H.J. HEINZ (HNZ, $58)**, which is making inroads into emerging markets; **PRECISION CASTPARTS (PCP, $173)**, which makes components that enable planes, such as the Boeing 787, to be more fuel-efficient; and **CVS CAREMARK (CVS, $47)**, which combines a drugstore chain with a pharmacy benefits-management business.

Dividend-paying stocks are already popular with investors—to the point that some high-yielders are a bit pricey. But this theme is expected to pay off for years, even though it's likely that the tax rate on dividend income will increase as a result of the bargaining in Washington (but probably not anywhere close to the worst-case scenario, which would bump the rate from 15% to 43.4% for high earners).

Dividends are likely to account for a rising portion of returns. So far in 2012, 287 firms in the S&P 500 have lifted or initiated payouts. The percentage of corporate income paid out in dividends, at an average of 28% for S&P companies, leaves plenty of room for growth. Companies that are raising dividends, such as retailer **KOHL'S (KSS, $54)**, with a yield of 2.3%, are better prospects than, say, telecom giant Verizon Communications (VZ, $43), which yields 4.6% but isn't as likely to boost its dividend as fast as Kohl's can. A good choice for fund investors is **VANGUARD DIVIDEND GROWTH (VDIGX)**, a member of the Kiplinger 25.

Q&A KATHERINE NIXON

A "PRETTY DECENT" YEAR AHEAD

KATHERINE NIXON *is chief investment officer for the personal financial services business at Northern Trust.*

KIPLINGER'S: WHAT'S YOUR OUTLOOK FOR STOCKS?
NIXON: We think it's going to be a pretty decent year. Our outlook is predicated on slow but steady growth in the U.S., stability in China, and a short and shallow recession in the European Union. We see earnings growth of 5% to 10% next year. Pop on top of that a 2.1% dividend yield, and you've got a compelling argument for decent stock returns. And you know that with $1.7 trillion in cash on the balance sheets of S&P 500 companies, they're spring-loaded either for a recovery in global demand or for some pretty shareholder-friendly activities, including initiating share buybacks and establishing or increasing dividends.

SO WHERE SHOULD INVESTORS FOCUS IN THE COMING YEAR? Sectors that have done well are a little bit more defensive. Health care companies, for instance, deliver slow and steady growth, and investors are favoring that dependability and consistency.

WILL THAT CONTINUE IN 2013? It probably will. A lot has to do with the fact that these tend to be companies that pay dividends. They pack a one-two punch of lower volatiity and higher income.

WHAT OTHER THEMES ARE YOU EMPHASIZING THIS YEAR? We just increased our allocation to emerging markets, recognizing that the China growth story is intact. Right now, we're overweighted in the U.S. and underweighted in stocks of developed foreign countries. Looking out 12 to 18 months, our middle-of-the-road portfolio has 11% of assets in emerging markets, 10% in international developed markets and 28% in U.S. stocks.

WHAT ABOUT BONDS? The best-case scenario in the high-grade fixed-income market right now is that you will earn what you get from clipping coupons. We are leaning toward high-yield bonds.

JAMES MICHELFELDER AND THERESE SOMMERSETH. MAKE-UP/HAIR: MARNI GIANNOTTI

The recovering economy is another promising theme for investors. Housing prices are firming or rising in most areas as inventories of unsold homes are whittled away. Builders are back at work, with housing starts up sharply. Building stocks have already come to life, but the rally is far from over, says Mark Luschini, chief investment strategist at Janney Montgomery Scott in Pittsburgh. One builder, **TOLL BROTHERS (TOL)**, is on our list of top picks for 2013. Luschini prefers the exchange-traded **ISHARES DOW JONES US HOME CONSTRUCTION ETF (ITB)**. The ETF is good for those who prefer to "buy the whole neighborhood rather than trying to pick the best house," says Luschini.

Autos are another key driver of the recovery. Vehicle demand reached a post-recession peak in September, according to IHS Global Insight, and the combination of an aging fleet needing replacement and easing credit bodes well for future growth. **FORD MOTOR (F, $11)** is the only U.S. carmaker to survive the recession without a bankruptcy or government bailout. Ford faces huge challenges in Europe, but in recent years it has cut costs, gained market share in the U.S. and won over consumers with its smaller, more fuel-efficient vehicles. It's one of columnist Jim Glassman's picks.

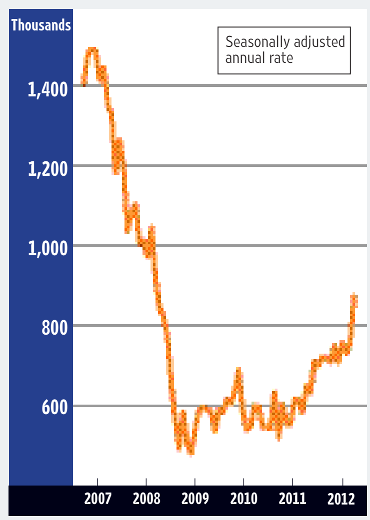
It can't hurt to play defense with at least some of your portfolio in 2013. Many pros recommend health care stocks for their strong demographic underpinnings, high yields and reasonable prices. David Darst, chief investment strategist with Morgan Stanley Wealth Management, who expects a flat-to-down market in 2013, likes medical-device maker **MEDTRONIC (MDT, $42)** and drug giant **PFIZER (PFE, $24)**. Both trade at less than 11 times estimated 2013 earnings. Darst is also sticking with what he calls "global gorillas," such as **JOHNSON & JOHNSON (JNJ, $70)** and **PROCTER & GAMBLE (PG, $68)**. ■

KEY INDICATORS

Hopeful Signs, Gloomy Investors

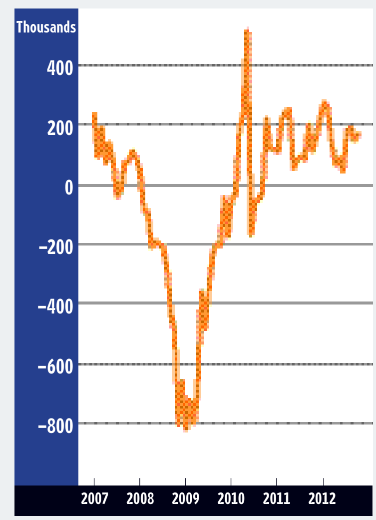
An improving housing market and a stable jobs picture suggest that corporate earnings will continue to rise in 2013. But investors are still pulling money out of U.S. stock funds despite the market's solid performance in 2012.

Housing: New Privately Owned Housing Units Started



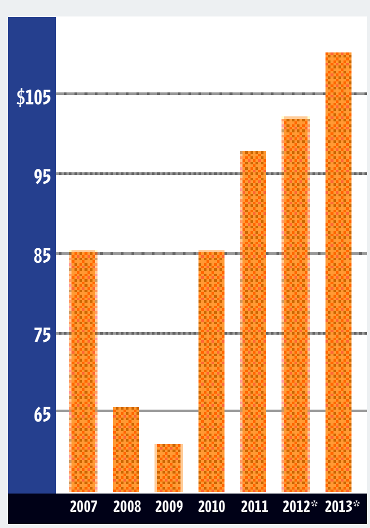
SOURCE: U.S. Census Bureau

Employment: Number of Jobs Created/Lost



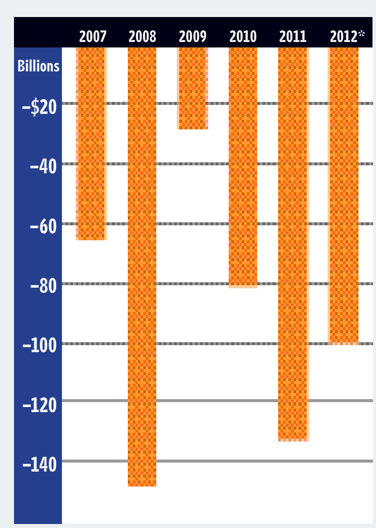
SOURCE: Bureau of Labor Statistics

S&P 500-Stock Index Earnings Per Share



*Estimate. SOURCE: Thomson Reuters I/B/E/S

Net Cash Outflows From U.S. Stock Funds



*Estimate. SOURCE: Investment Company Institute, TrimTabs.com