



MONTHLY MARKET COMMENTARY

INNOVEST December 2011

The Economy

The U.S.

Prospects for the U.S. economy ended 2011 on a positive note with economic reports that were stronger than expected. The U.S. continues to recover from the recession of 2008-2009, albeit at a glacial pace. December marked a month in which the economy expanded and consumer confidence improved. While it is still easy to take a rather gloomy view of the U.S. economy, evidence suggests that things are getting better.

The economic recovery remains fragile. The consensus expectation from economists and Wall Street is that U.S. GDP growth will be in the range of 2-3% in 2012. Fed Chairman Ben Bernanke faces a monumentally challenging task these days. Having exhausted nearly every reasonable form of monetary stimulus, the Fed is essentially “out of bullets” should the economy face any new economic enemies. Bernanke & Co. have lowered short term interest rates to near zero. They have conducted two rounds of quantitative easing. They have doubled the size of the Fed’s balance sheet in the past three years to nearly \$3 trillion. All of these extraordinary measures have worked to some degree, but will likely lose their marginal impact on a forward looking basis.

The current state of the U.S. economy, and Chairman Bernanke’s plight, remind us of the Garth Brooks song “Much Too Young.”

All my cards are on the table with no ace left in the hole

I’m much too young to feel this damn old...

The worn out tape of Chris Ledoux, lonely women and bad booze

Seem to be the only friends I’ve left at all.

Yet there is reason for mild optimism. December’s ISM Manufacturing survey rose to 53.9, the fastest pace in six months and well above expectations. Importantly, factories hired workers last month at the highest rate since June. The Commerce Department reported a 1.2% increase in construction spending in November, the third increase in four months. Consumer spending for the holidays was solid, a boon for many U.S. retailers. Retail sales were up 4.5% in December, ahead of estimates.

Encouragingly, the drivers for economic growth in 2012 remain in place. The Fed will likely remain as accommodative as possible this year, which would repeat a long-term pattern of the Fed trying to stimulate growth in election years. Government spending probably will be flat, while productivity gains from technology should continue to increase. These combined factors point to a relatively decent year for economic activity in the United States, despite our urge to commiserate with Garth Brooks.

The World

Global economic growth will likely be slower in 2012, as potential woes stretch from Western Europe to the emerging markets. The World Bank estimates global GDP growth at 3.6%, while Goldman Sachs forecasts a less optimistic 3.2% worldwide growth rate. The world will likely grow at a faster clip than the U.S., but the forecast for 2012 is certainly muted.

Uncertainty is the name of the game. Europe’s financial problems have not gone away and will take time to fix. Though progress is being made, the specter of financial contagion spreading from Italy to other large countries in the EMU has kept the markets nervous. China is experiencing a meaningful slowdown, despite attempts by Beijing to loosen economic controls. Russia faces a disorderly political transition, as Vladimir Putin seeks to reclaim the Presidency. The Atlantic estimates that this year there are political handovers in countries whose economies total roughly 50% of world GDP. The U.S., China, France, Russia, Mexico, Venezuela, Kenya, Taiwan and Egypt all face political transitions.

Prospects for an economically healthy 2012 largely revolve around Europe. The U.S. and Asia count the Eurozone as one of their biggest markets for exports. Europe is already in a mild recession. A further deterioration in sovereign debt yields could spell greater trouble for the European economy at large. This would in turn have a decidedly negative impact the demand for U.S. and Chinese exported goods.

To the surprise of absolutely no one, Kim Kardashian and her NBA pseudo-star husband, Kris Humphries, filed for divorce this fall. Their marriage lasted a lengthy seventy-two days. According to reports, Kardashian’s endorsement payout for the wedding totaled some \$18 million. In short, Ms. Kardashian couldn’t not get married—even if the arrangement was doomed to failure from the start.

The dynamic between Greece and the rest of Europe is not unlike the Kardashian/Humphries pairing. Nearly everyone agrees that Greece’s participation in the Euro has proven to be an unmitigated disaster. There were signs of trouble from the start (anyone following the Kardashian E! reality show could see also foresee trouble). Twelve years ago, however, the prospect of lower borrowing costs and greater fiscal legitimacy meant that the Greeks couldn’t not adopt the Euro. A passionate shotgun marriage ensued between Greece and the Euro in 2000. A divorce is likely forthcoming for Greece and the Euro in 2012 or 2013, due to “irreconcilable differences,” in this case of the fiscal variety.

There are bright spots in the emerging markets. Despite increasing pessimism, both China and India have proven resilient in their latest economic reports. China’s non-manufacturing Purchasing Managers’ Index (PMI) rose to 56 in December, well ahead of estimates. India’s Purchasing Managers’ Index jumped to 54.2, the highest in six months. As inflation shows signs of easing, India’s central bank will likely take a more pro-growth approach. A more accommodative India should drive output across the region.



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The U.S. equity markets enjoyed a mild Santa Claus rally in December. For the month, the S&P 500 was up 1.02%. Bad news from Europe was tempered by positive economic reports domestically. The Dow Jones Industrial Average finished the year up 5.53%. Before accounting for dividends, the S&P 500 finished the year essentially flat—the exact figure was registered a loss off 0.0028%. This move in the S&P 500 was the smallest on an annual basis since 1947. From a total return perspective the Index returned 2.11%, which includes dividends. Encouragingly, companies in the S&P 500 experienced record quarterly profits in 2011.

Greater profits and a flat S&P 500 signal attractive values for the U.S. stock market.

Global equities were down slightly in December. For the month, the MSCI EAFE Index posted a negative 0.95% return. Much of the loss was due to a depreciation of the Euro, which continues to fall rapidly. The Euro now trades below 1.28 to the U.S. dollar, the lowest level since September 2010. Emerging markets declined in December as well. The MSCI EM Index was down 1.21% for the month.

Bonds posted positive gains in December. The Barclays U.S. Aggregate Index was up 1.10% on the back of anxiety about Europe and a continuation of low interest rate targets in the U.S. Corporate bonds gained 2.14%, while high yield bonds registered a 2.66% gain. Just when you thought U.S. bond yields couldn't go any lower, they did. The 10-year U.S. Treasury bond yielded 1.89% on the last day of 2011.

The Dow Jones UBS Commodity Index was down 3.75% in December. Gold futures fell 3.4% in the fourth quarter of 2011, as it appeared that some of the air is escaping from the precious metals bubble. Energy prices are the subject of competing forces. A stronger U.S. dollar has made oil cheaper, while increased saber-rattling from Iran added a higher premium to a barrel of oil.

Outlook

Sadly, writer and intellectual Christopher Hitchens passed away in December after a bout with cancer. He was both an influential conservative thinker and an avowed atheist, much to the chagrin of both liberals and social conservatives alike. He embraced the principal of uncertainty in his philosophy on life and religion.

Hitchens once noted in a televised debate: “The only thing that is certain is the principle of uncertainty.” And so it is, too, with the short-term direction of the financial markets and the health of the world economy. The next few months could prove volatile on the downside. They could also bring a surprising amount of good news, especially should fiscal problems in the Eurozone be contained. Only time will tell.

As long term investors, we retain a greater degree of certainty. We know that over the long term, businesses in the U.S. and abroad are very likely to continue growing and remain profitable. These earnings will eventually translate into equity market gains. Fixed income investments will provide yield in portfolios (however meager) and act as a stable counterweight to stocks. A fully invested and diversified strategic allocation is designed to provide returns above and beyond inflation, with lower volatility.

Byron Wien, currently Vice Chairman of Blackstone Advisory Partners, publishes a list of “surprises” each year. In years past, many of his expectations have proven unusually prescient. Happily, his predictions for the new year are on the optimistic side. Among his predictions for 2012: \$85 oil due to an increase in shale extraction, the S&P 500 finishing above 1400 and real GDP growth in the U.S. above 3%. He also expects Europe to come to terms with its fiscal problems and establish a broad plan. If even one-half of his predictions come true, it should be a relatively good year. In the interim, we learn to deal with the certainty of uncertainty.