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Weekly Investment Commentary

Muddling Through in 2012

January 9, 2012

Stocks Rise on Improving Economic Data

The first week of 2012 was a positive one for risk assets as the flow of economic releases continued to be somewhat better than expected. Markets in the United States focused on the positive last week, and looked past rising oil prices and some data from Europe showing that a recession in that region was growing increasingly likely. For the week, the Dow Jones Industrial Average climbed 1.2% to 12,359, the S&P 500 Index advanced 1.6% to 1,277 and the Nasdaq Composite rose 2.7% to 2,674.

The US Economy Continues to Accelerate

Recent positive economic data includes rising levels of construction spending, better manufacturing data and, perhaps most importantly, signs of improvement in the labor market. The December employment report was released last Friday, and showed that private payrolls grew by more than 200,000 jobs in the last month of 2011. The report also showed increases in average hourly earnings and the length of the workweek.

Importantly, the data also showed that unemployment fell to 8.5%. This is still, of course, a very high number by historical standards, and it would not be a surprise to see the number tick higher in the coming months as this indicator can be somewhat volatile, but it is important to note that the unemployment rate is now 1.5% lower than its peak in October 2009. It is beginning to look as if the economy is forming a positive feedback loop in which improving labor conditions are feeding into better conditions elsewhere in the economy, given that consumers are also benefitting from some stabilization in housing data and improved access to credit.

Over the last month, most economists have been quickly upgrading their forecasts for fourth quarter 2011 gross domestic product growth, and at this point it appears that growth for the quarter will come in somewhere over the 3% mark. Looking ahead, we also expect that we will see upward revisions for the first quarter of 2012.

Risks in Europe Remain Elevated

In contrast to the data trends in the United States, the numbers in Europe are continuing to point to some sort of recession in 2012. Concerns over Europe, the future of the eurozone and the debt crisis in that region continue to be the main risks holding investors back. These fears were reinforced last week as we saw some bank debt issuance difficulties and some mounting fiscal pressures in Italy and Spain.

The outlook for Europe is clouded, but there are some ways that the situation could improve. On the fiscal policy front, we would look for policymakers to make more of a move toward fiscal integration and a greater centralizing of budgetary decisions. We could also see, at some point, the issuance of a Eurobond. On the monetary side, the European Central Bank could engage in a quantitative easing program, perhaps by purchasing sovereign bonds. There is little sign that this will happen at this point, but should we see some sort of "market riot," the likelihood would increase.

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Calling for a "Muddle Through" World in 2012

As we have been saying for some time now, the world continues to operate in a post-credit-bust environment in which significant amounts of deleveraging still need to occur. The momentum in the United States is pointing in the right direction, but we do expect to see ongoing back-and-forth in the tone of economic data. Conditions will not continue to improve at the same pace we have seen over the last couple of months, nor will they deteriorate to the point that a double-dip recession becomes likely. Instead, we expect the economy to chart a middle course and grow somewhere between 2% and 2.5% for the year.

This sort of environment should be one in which risk assets (chiefly US stocks) should be able to post decent gains. The main risk, of course, continues to be the European debt crisis and while our base-case scenario is one in which uneven progress is made, the risks of a breakdown in the healing process are real and could derail our forecast.

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