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The Economy: A Brighter Picture

The U.S.

February was a positive month for the economic outlook and for financial markets. The country's most famous groundhog, Punxsutawney Phil, saw his shadow on February 2nd. As a result, six more weeks of winter were predicted. The U.S. economy did not see its shadow, however, as we witnessed continued signs of economic progress.

The U.S. is improving at a slightly faster clip than most economists had originally predicted in 2012. Renewed, though guarded, optimism has emerged. U.S. industrial output gained once again in February, marking the 33rd consecutive month of expansion. For the year, consensus expectations are for U.S. economic growth of about 2.5%.

A surprising adjective is being used to describe the U.S. economy: *resilient*. Several sectors within the economy have grown markedly over the past months. Oil and gas production has increased domestically, driven by rising energy prices and improved fracking technology. Motor vehicle sales are up sharply, leading to more output from manufacturers. The assembly lines in Detroit are beginning to run a third shift. The U.S. service sector, which employs four out of five American workers, grew at a faster pace in February than the economy in general.

Accomodative monetary policy from the U.S. government has contributed greatly to economic gains. Record low interest rates have made it easier for Americans to deal with their existing debt. For U.S. households, interest expenses on mortgages and consumer credit have declined by 25% since 2008. Interest payments now comprise 6% of disposable income for the average American family, down from 9% in 2007.

Fed Chairman Ben Bernanke testified before Congress on February 29th. Bernanke's testimony indicated mixed feelings about the U.S economy. He explained that private sector job growth over the past months has been strong and greater than expected. Meanwhile, U.S. GDP growth is below trend and there remains a good deal of slack in the economy. Capacity utilization rates continue to lag historical averages. The Fed has debated another round of quantitative easing. Ideally, Bernanke is targeting a "Goldilocks" outcome for economic growth—policy that's not too hot and not too cold.

The World

Global economic prospects improved in February, owing mostly to better news coming out of Europe. Concerns eased regarding several of the factors that have dogged the global economy over the past months.

The European debt crisis is inching towards resolution. A second EU/IMF Greek bailout was approved at the end of February. The bailout package allows Greece to meet its debt payments, giving them a fresh €130 billion. Private bondholders of Greek debt will have to take a 53.5% "haircut" on the value of their bonds. In return for this arrangement, the Greek government has agreed to a wide variety of austerity measures. The aim is to reduce Greek's sovereign debt to 120.5% of its GDP by the year 2020. Private bondholders have to approve the deal on March 8th.

With new leadership under President Mario Draghi, the European Central Bank is becoming increasingly accommodative with its monetary policy. From December 21 to February 29, the ECB offered European banks a total of €1 trillion in low interest loans. The loans are for up to three years and charge 1% annual interest. This is a massive liquidity push to ease concerns over troubled bank balance sheets. It appears to be working as fears eased significantly in February. The issue of solvency among major German and French banks, however, is still up for debate.

Despite progress, European leaders cannot rest on their laurels. Most of the continent remains in a recession. The austerity measures that have been implemented across the peripheral countries like Greece and Ireland will only contribute to lower growth and higher unemployment in the short run. Eurozone unemployment rose to 10.7% in February, the highest jobless rate since the implementation of the Euro in 1999. It will take years for Europe to return to true financial health.

China delivered somewhat somber news regarding its own economy in 2012. The Chinese government predicted GDP growth of 7.5% this year, down markedly from 9.2% in 2011. Concerns about inflation and a hard landing for China's urban real estate markets drove a tightening in monetary policy. Historically, China has targeted economic growth above 8% as part of a plan to accommodate new entrants into the workforce.

The price of crude oil continues to be a major factor in the health of the global economy. Economists estimate that a sustained 10% rise in the price of crude oil could impede global growth by 0.2% and boost inflation by 0.2%. Brent crude climbed 10% in February to $120 per barrel, while WTI crude rose 9% to $107 per barrel. A significant risk premium has been built into the price of crude in 2012, due mostly to a heightening of tensions around Iran's nuclear program. Israel is contemplating a preemptive strike on Iran's burgeoning nuclear facilities, a move that would undoubtedly impact global oil supplies.

The Markets: Risk-on Rally

The U.S. equity markets were up significantly in February, building upon gains from January. For the month, the S&P 500 was up 4.32%. The S&P 500 ended February up 8.91% year to date. Increased optimism for the economy at home was coupled with decreasing fears of a European financial crisis.

Global equities also rallied in February. On the back of a European Union and IMF bailout for Greece, the MSCI EAFE Index was up 10.43% for the month. Emerging markets have appreciated massively in the New Year. In February, the MSCI Emerging Markets Index rose 16.52%. Emerging markets are often a higher

beta exposure to global economic conditions—in this case an easing of financial fears delivered huge gains to these markets.

Bonds registered some gains in February. The Barclays U.S. Aggregate Index was up 0.79% as spreads continue to move lower. Borrowing costs for companies worldwide are approaching record lows. The U.S. corporate bond index rallied 2.95%, while the high yield index rose 5.43%.

The Dow Jones UBS Commodity Index was up 4.07% in February. Rising oil prices contributed to much of the gain in commodities. Natural gas continues to reach record lows as new technology and a mild winter in much of North America have created a supply imbalance. Gold prices declined as the prospects for a new round of quantitative easing in the U.S. decreased slightly.

Closing Thoughts

The late writer David Foster Wallace told the following story during a graduation speech at Kenyon College some years ago:

There are these two young fish swimming along, and they happen to meet an older fish swimming the other way, who nods at them and says, "Morning, boys, how's the water?" And the two young fish swim on for a bit, and then eventually one of them looks over at the other and goes, "What the hell is water?"… The immediate point of the fish story is that the most obvious, ubiquitous, important realities are often the ones that are the hardest to see and talk about.

The big picture still matters a great deal in the financial markets. It is easy to get lost in the day-to-day headlines of the world economy, including the financial crisis in Europe and the geopolitical struggles of the Middle East. Whether your outlook is optimistic or pessimistic, ample data are at your disposal. Still, acting on your outlook to make large tactical shifts in your investment portfolio would be a mistake.

It is nearly impossible to time markets. Staying the course and maintaining a strategic investment allocation is one of the most important, and oft ignored, realities of investing. Retail investors follow headlines and lose sight of what matters.

The outlook for the U.S. economy and the financial markets appears to be relatively positive, though not without significant headwinds. We hope to see continued surprises to the upside in the U.S. economy, coupled with an easing of fiscal fears in Europe. A combination of these two will continue to be a boon for financial markets. And while Groundhog Day brought more winter for the citizens of Pennsylvania this year, there are signs of spring in previously struggling economies around the world. Perhaps the better economic news will deliver increasingly improved investment results.