

Weekly Investment Commentary

Double-Digit Market Returns in 2012?

January 17, 2012

Stocks Post a Strong Start to 2012

Following strong gains in the first trading week of the year, stocks were up again last week, with the Dow Jones Industrial Average climbing 0.5% to 12,422, the S&P 500 Index rising 0.9% to 1,289 and the Nasdaq Composite advancing 1.4% to 2,710.

Skeptics would suggest that the solid start to 2012 is little more than a typical “January effect” in which stocks tend to rise at the beginning of the year, but we think there is more to it than that. In part, we believe the upward moves of the last two weeks can be attributed to the fact that many investors (including active fund managers) came into the year underexposed to risk assets following a disappointing 2011, and who are at this point beginning to put their cash to work.

Containing Risks Is Critical to the 2012 Outlook

So what will it take for the market’s winning ways to continue in the year ahead? We are cautiously optimistic that good returns for stocks will not require strong economic or earnings growth this year, nor will they require significant upside surprises. In our view, given that expectations and investor sentiment are quite depressed, if the world is able to avoid major accidents and policy mistakes and if existing sources of risk are contained, we should see some decline in volatility levels and a diminishing of investor uncertainty and fear. These trends, in turn, should allow more investors to move back into the markets.

The primary source of risk has been, and remains, the sovereign debt crisis in Europe. In our opinion, European policymakers will do what is needed to avoid an outright catastrophe or a disintegration of the European Monetary Union, but we are not expecting to see wholesale solutions to the issues plaguing Europe. The economic outlook for Europe is a poor one and is one that has been made worse by austerity measures that are required for sovereign debt issuers to maintain or regain investor confidence.

At this point, it is all but certain that Europe will slide into a recession this year, but it will hopefully be a mild one. A recession would obviously cause a decline in economic growth and employment levels, but the one bright side is that a recession would also help bring down inflation pressures in Europe, which were a concern as recently as one year ago. Today, in contrast, Europe’s concerns are more about deflation, which should pave the way for the European Central Bank (ECB) to engage in additional easing measures. We believe the ECB is likely to continue to cut short-term interest rates until some sort of floor is reached and we also expect to see the ECB engage in quantitative easing via expanding its balance sheet by acquiring some combination of public or private assets. Lower rates and quantitative easing will not be a panacea for the euro debt crisis, but they would be steps in the right direction.



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Outside of Europe, investors are also concerned about US fiscal policy and a potential hard landing in China. In the United States, the fiscal policy wars that dominated much of the 2011 political backdrop seem to have faded somewhat in advance of the upcoming elections. Both Democrats and Republicans seem to have gotten the message that voters care more about the economy and jobs than they do about fiscal policy, so we expect major policy decisions to be delayed until after the November elections.

Regarding China, while it is clear that economic growth is slowing, we believe that the corrections in the real estate market and in the banking system are fundamentally different than what caused the economic crises in the United States and, now, in Europe. Our view is that by the middle of 2012, economic clarity should emerge in China and that it should become clearer that that country is facing a slowdown and not an economic collapse.

Stocks Likely to Outperform in 2012

The risks we outlined are certainly serious ones, and it is of course possible that some sort of shock could emerge that could derail the global economy (possibly in the form of a geopolitical crisis in the Middle East). Nevertheless, our view is that unless the world enters into a global recession in 2012, equity markets should outperform bonds and cash this year.

We are not suggesting that stocks will move inexorably higher this year and we are quite certain that we have not seen the end of market volatility. We do believe, however, that decent earnings prospects, plus dividend yields plus a moderate improvement in valuations should be enough for US stocks to post double-digit returns in 2012.

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