Situation Analysis:
2011 Review & 2012 Outlook

2011: Europe in crisis while the world struggled forward

2011 had a tough act to follow. 2010 was a good year for capital markets, domestically and globally. 2011 turned out to be a year with an extraordinarily large number of geo-political, natural disaster and financial crisis events which contributed to a sense of confusion and uncertainty in capital markets, impaired economic growth, sustained volatility in markets, and ultimately depressed stock values globally. Returns from U.S. bond markets were strong as investors sought potentially safer places to weather the stressful year and shifted money into fixed income instruments. Despite a wild ride, U.S. stock markets were basically flat for the year. However, international stocks fared poorly with overseas banks particularly hard hit and currencies, like the euro, losing value. Commodities markets struggled as investors appeared to reduce exposure to risk areas of the market and as demand waned from slowing economies across the globe. Commercial real estate continued to show improved performance as an asset class, although real estate securities were hit fairly hard during the most volatile periods of the year.

In the U.S., economists anticipated a reasonably strong economy, perhaps as much as 4% growth in Gross Domestic Product (GDP). However, stimulus programs from the Great Recession expired, removing some of the fuel from our economic engine. Our forecasts for more modest growth in the U.S. economy, turned out to be accurate.

Europe grabbed many of the headlines. While periphery countries of the European Union (EU), such as Greece, Portugal and Ireland were struggling, the core European economy appeared early in the year to be stronger than the economy of the U.S. The European Central Bank (ECB) focused on tightening the money supply because the fairly robust EU economy was starting to run the risk of accelerated inflation. The United Kingdom embarked on an aggressive cost cutting strategy to repair its balance sheets from the debt incurred during the 2008 crash.

Emerging economies had been growing at unsustainably high rates since 2009. Central banks in these countries continued a second year of monetary tightening designed to dampen inflation that had risen to damaging levels in countries like Brazil.

Unfortunately, just as the year was getting started, Japan, the world’s third largest economy and an integral contributor to the global supply chain, experienced a tragic earthquake, tsunami and resultant nuclear disaster. Japan’s economy tipped into recession and manufacturers across the globe suffered from supply disruptions. Important industries like automotive companies were constrained, putting downward pressure on the global economy.

At the same time, political pressures and civil unrest within several Middle Eastern countries quickly reached a boiling point, resulting in a series of revolutions in countries such as Egypt and Libya. As typically happens during turbulent periods in the Middle East, the price of oil was pushed to high levels that further restrained global economic growth.
By spring, it was apparent that Greece was in financial crisis and at risk of default on its government debt. The EU went into emergency response mode, creating a fund similar to the Troubled Asset Relief Program (TARP) put in place in the U.S. in 2008. It was designed to provide relief to Greece in particular, as well as a number of other EU member states under stress. While Greece is a very small economy and its potential default would not unduly burden the EU as a whole, the fear is that several members of the EU could follow a similar path, almost like a spreading infection. If several EU countries went into crisis, potentially including larger economies like Italy or Spain, it could overwhelm the entire EU economy. As crisis conditions worsened in the EU, collateral effects were felt in the U.S. and in emerging economies, including China and India.

The twin effects of the Japanese disaster and the imminent crisis in the EU resulted in second quarter economic growth in the U.S. being far slower than anticipated. As a result, investment markets in risk-type assets (stocks, commodities, credits) suffered. As the EU worked to stabilize the situation in Greece and as Japan slowly rebuilt, the U.S. found itself in a political standoff over a procedural vote to raise the federal government’s debt ceiling. It threatened a government shutdown. This highly visible brinksmanship in the world’s largest economy sent shock waves through capital markets and appeared to damage investor confidence across the globe.

As the global economy slowed, several emerging market countries began to ease monetary policies, helping those countries maintain their growth rates in spite of events across the developed world.

Although the U.S. Congress achieved a compromise to extend the government debt ceiling and sidelined the shutdown threat, financial conditions in the EU worsened considerably. Spain and Italy (the third largest EU economy) suddenly took center stage. Markets were rocked through September with increased concerns about a full-fledged banking crisis in Europe.

Yet as the European crisis became more critical, the U.S. economy actually strengthened, at least modestly, and Japan recovered dramatically from two quarters of negative growth due to the massive investments in rebuilding. In October, on the heels of five consecutive months of negative returns, the U.S. stock market (as measured by the S&P 500 Index) enjoyed its best month in two decades.

Unfortunately, crisis conditions in Europe began to involve several other member countries including France, Germany’s main financial foundation partner. The new Chairman of the ECB, acknowledging that the risks of serious inflation in the EU were not as great a concern as the possibility of a European recession, cut its key lending rate. Ultimately, in November, even the German bond market experienced weak demand and European banks were on the brink of a liquidity crisis. In an emergency action, central banks from around the world, led by the U.S. Federal Reserve, extended an unlimited credit facility to European banks. At the same time, Germany and France announced plans for greater fiscal control policies across the EU. Stock markets rallied strongly on the news of the central banks’ liquidity action and the new EU fiscal program. In an effort to gain control over its spiraling debt, Italy announced a relatively significant spending cut program to be enacted over the next three years. This announcement was an encouraging sign that members of the EU are determined to improve their respective balance sheets. However, the EU has not yet implemented true structural reforms and until it does, markets are likely to remain guarded and somewhat skeptical.

As the year 2011 closed, we observed the global economy slowing as a result of the myriad challenges and stresses during this unique year. We believe the U.S. economy is gradually improving, probably growing at a 2.5% to 3% rate during the fourth quarter. By contrast, the European economy appears to already be tipping into recession due to its financial crisis. The depth and extent of a European recession is dependent on the timeliness and effectiveness of whatever structural changes EU leadership actually implements. Economic growth in Japan is still positive during this post-disaster period, but is certainly not robust. The economies of the emerging world have slowed as a result of weak demand from the developed world. Annual GDP growth in China appears to be approximately 8%. In India, it is likely to be 6.5% to 7%. Growth in Brazil may have stalled completely.
2012: Europe stabilizes while the world grows

Turning to 2012, we see a period that will probably feel like an aftermath from the crisis-filled 2011. With the full disclosure that we don’t have a proverbial crystal ball, we anticipate that growth in the U.S. economy is likely to remain near 2%, buoyed by the fact that 2012 is a presidential election year. If nothing else, all of the campaign spending that goes along with our modern political process may be, in a small way, its own economic stimulus program. We anticipate that growth in emerging market countries will stabilize and begin to improve throughout the year as monetary easing policies have their desired effect. Japan’s economy is likely to gradually slow as the impact of reconstruction spending wanes. Other than unforeseeable events that could happen in, for example, the Middle East, Europe will likely remain the main source of global concerns.

While it is not possible to predict specific actions that EU leaders may agree to in resolving its crisis, we anticipate that in general, the EU will be forced by capital market pressure on EU member bond issuers (through higher interest rates) to institute real fiscal controls across the eurozone. With Germany being the key country that may be able to provide financial stability for Europe, the plan should be convincing to German decision-makers. However, there will likely be flare-ups of crisis conditions during the process. In our opinion, the ebb and flow of negotiating a resolution is likely to result in elevated market volatility in general and periodic spikes of volatility that could cause stock markets to reel from time to time. As a result of continued crisis conditions in Europe, we believe the EU economy will likely experience a recession through the first half of 2012. We expect the ECB to take action to try to limit the degree of any downturn. Nevertheless, we anticipate weak demand from the EU will restrain global growth in 2012, causing emerging market countries to continue to implement more of the easing policies that gathered momentum in 2011.

Fixed Income: In our opinion, the U.S. bond market is likely to start 2012 still in a “wait and see” posture until tangible evidence of EU actions appears. If the European crisis conditions subside, we think the bond market will initially shift out of crisis valuation and begin to price in expectations for decent growth in the U.S., and higher levels of inflation. We anticipate interest rates on Treasury bonds could rise as early as mid year, with bond values falling. In this environment, we anticipate that sectors like high yield bonds should perform reasonably well, and in light of expected higher interest rates, hedged debt investment styles should be emphasized when suitable for portfolios.

Equities: We believe the U.S. stock market is likely to deliver decent returns in 2012. Earnings across the S&P 500, which grew nicely during 2011, will probably grow more slowly in 2012. However, if the European crisis is slowly resolved, the valuation of stocks should improve, resulting in what could be a low double-digit year for returns on stocks. In anticipation of a year with likely divergent returns between bonds and stocks, and with continued high volatility, we prefer active stock management styles over passive approaches, including hedged equity styles when appropriate.

International: International investments are likely to perform better in 2012 if the European crisis eases. Investors appear to have already priced in the impact of major trauma in the EU, a situation we think is unlikely to occur. If the European situation is resolved, the market as it stands today may present a good opportunity for significant price recovery. Emerging market stocks suffered in 2011 because of the link to the EU as a major trading zone. Here again, the likely opportunity is a move towards more normal valuations across the emerging world. We also anticipate that the U.S. dollar may trend downward versus key foreign currencies in 2012, which may boost returns for U.S. investors in international markets. Given that the U.S. will be in presidential election mode in 2012, we suspect that no real progress will be made on America’s fiscal situation until after the election. Capital markets may likely respond by putting pressure on the dollar.

Commodities: It is our belief that commodities markets are likely to have a modest year. Global demand, especially from emerging markets is anticipated to be sub-par in 2012. Several key commodities are in tight supply conditions. With emerging market countries engaged in monetary easing, we believe this may leave room for surprisingly stronger prices, potentially
driven by stronger global economic activity. However, commodities markets tend to be rocked by unforeseeable events like severe weather, but barring that, economic growth is the foundation of commodity demand.

Real Estate: Real estate investments should become increasingly attractive in 2012, in our opinion. Gradually improving supply conditions, coupled with moderate growth in demand from the U.S. economy, may produce attractive returns for many areas of commercial real estate. In addition, with the potential for higher inflation on the horizon, real estate investments should be emphasized as appropriate because, as an asset class, real estate has historically generated positive performance during periods when costs rise more dramatically.

Outlook Conclusions: Overall, our view is that investment conditions are improving and opportunities in 2012 appear reasonably attractive, especially for risk-type assets like stocks, commodities, real estate and credit securities. However, with higher volatility expected to continue, it is important to pay close attention to individual investment objectives. Investors with short-term objectives should remain fairly conservative. Longer term investors may benefit by looking beyond the expected near-term volatility to take advantage of what could be improved returns from risk assets over an extended holding period.

IMPORTANT DISCLOSURES

This information was developed as of December 27, 2011 and represents the opinion of U.S. Bank Asset Management Group. It does not constitute investment advice and is issued without regard to specific investment objectives or the financial situation of any particular individual. Since economic and market conditions change frequently, there can be no assurance that the trends described here will continue or that the forecasts will come to pass. The information presented is for discussion purposes only and is not intended to serve as a recommendation or solicitation for the purchase or sale of any type of security. The factual information provided has been obtained from sources believed to be reliable, but is not guaranteed as to accuracy or completeness. U.S. Bank is not responsible for and does guarantee the products, services or performance of its affiliates or third-party providers.

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Based on our strategic approach to creating diversified portfolios, guidelines are in place concerning how investments should be allocated to specific asset classes based on client goals, objectives and tolerance for risk. Not all recommended asset classes will be suitable for every portfolio. Hedged equity and hedged fixed income investment strategies are typically available via hedge funds which may not be appropriate for all clients due to the speculative nature and high degree of risk involved in these investments.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. International investing involves special risks, including foreign taxation, currency risks, risks associated with possible difference in financial standards and other risks associated with future political and economic developments. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in fixed income securities is subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer term debt securities. Investments in lower rated and non rated securities present a greater risk of loss to principal and interest than higher rated securities. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties, such as rental defaults. Alternative investments very often use speculative investment and trading strategies. There is no guarantee the investment program will be successful. Alternative investments may not be suitable for every investor, even if the investor does meet the financial requirements. It is important for investors to consult with their investment professional prior to investment in these investments. Hedge funds are speculative and involve a substantially more complicated set of risk factors than traditional investments in stocks or bonds, including the risks of using derivatives, leverage and short sales, which can magnify potential losses or gains. Restrictions exist on the ability to redeem units in a hedge fund.