In recent months, economic sentiment has oscillated between fears of a double dip recession and expectations for a strengthening and durable domestic recovery. The swing in sentiment reflects underlying economic imbalances on a global basis and governmental policy responses to these imbalances – as well as their effects on financial market conditions. There is certainly room for differing interpretations of data that has sent conflicting signals in recent months. However, we have not changed our U.S. outlook for 2012 as we approach the turn of the year. We continue to expect the U.S. economy to stagger forward, but the growth trend will remain slower than the period prior to the recession in 2008 and 2009.

This assumes that current payroll tax rates will be extended through 2012, which will allow the household sector to avoid a substantial hit to disposable income at a time when the trend in real disposable income growth is very weak. Congressional leaders have indicated that Congress will not recess for the holidays until they reach an agreement on the payroll tax, so the likelihood of an extension for 2012 is favorable. But just as the Europeans have been accused of kicking the can down the road as it relates to their sovereign credit situation, Congress will only be delaying this adjustment until 2013. At that time, Congress must also address the sunset of current income tax rates and the automatic spending reductions triggered by the Supercommittee’s failure to reach a deficit reduction agreement. Policy decisions and their effect on economic performance will remain a key source of economic uncertainty next year.

**Growth to Decelerate in Early 2012**

The tone of economic data reports has been favorable in recent months. The economy will likely post its strongest pace of gross domestic product (GDP) growth for the year during the fourth quarter, which has contributed to some recent optimism for the coming quarters.

But the acceleration of GDP growth in the second half of 2011 will not likely continue into the first half of 2012 for the following reasons:

- Business investment in equipment and software has been strong during the second half of the year, a trend that in no small part is due to accelerated depreciation provisions of last year’s stimulus act for equipment put in place this year. This has most likely borrowed from next year’s capital spending, and we should expect a meaningful slowdown during the first half of next year.

- Organization for Economic Co-operation and Development (OECD) leading indicators suggest economic growth is decelerating sharply in Europe and to date more gradually in Asia. Overall, the slowdown in global growth will likely result in sharply slower export growth in 2012.
Fiscal policy is set to produce a more meaningful drag on economic growth in 2012, even assuming unemployment benefits and payroll tax rates are extended.

The recent acceleration in consumer spending has been driven by a decline in personal savings. The deterioration in household net worth over the past several months and the current low rate of saving suggests there is limited scope for a further decline in savings to drive a further acceleration in consumption spending.

These factors suggest that we will likely see the pace of growth decelerate in early 2012 before reverting toward a more trend-like pace of 2.0 - 2.5 percent during the second half of the year, barring negative shocks from the rest of the world or domestic policy failures.

Inflation Measures Look to Have Peaked

Inflation measures look to have peaked in recent months and should continue to trend lower at least through the first half of 2012:

- Labor compensation growth remains very anemic.
- Slower global economic growth should continue to provide relief for global resource prices.
- Modest strengthening in the dollar since the mid part of the year will limit import price pressures.
Aggregate credit growth remains modest, despite ballooning federal government debt, and reinforces the view that conditions remain absent for a sustained acceleration in inflation pressures. Unemployment will likely remain elevated throughout 2012, as a meaningful decline would require a much stronger growth environment than we envision in our forecast. Thus the Federal Reserve (the Fed) will continue with its guidance that it will keep the Fed funds rate unchanged until at least mid-2013, and further quantitative easing efforts will remain a possibility – particularly if credit strains originating outside the United States re-intensify.

Appropriate Policy Choices in Europe are Critical

The forecast for continued expansion in 2012 also depends on avoiding an apocalyptic end to the sovereign credit situation in Europe. A recession is almost certainly now underway in Europe and debt reduction will be necessary for certain countries. But appropriate policy choices to limit the depth, duration and potential contagion from those events will be critical to the U.S. outlook in 2012. It is not clear that policymakers in Europe are either currently willing or capable (due to domestic political considerations) of making policy decisions that will fully address the sovereign credit situation. Thus, this will likely remain a considerable source of uncertainty, market volatility and downside risk to the global and U.S. growth outlook again in 2012.

Several European economies are overburdened by the level of debt outstanding and markets have come to question the debt’s sustainability, particularly as these economies lack economic competitiveness. To reduce debt burdens and restore competitiveness, these economies will be faced with austerity and labor cost deflation for an extended period of time. These countries could potentially choose to restructure outstanding debt and restore competitiveness through currency devaluation by leaving the European currency union, but this option would also entail significant, if not greater, costs. The desire to avoid or minimize these costs by competing parties is the primary reason a resolution to the European situation has remained elusive.
Mid-Term Outlook Reflects Private Sector Healing and Governmental Sector Deterioration

Beyond these drivers of growth for the next few quarters, the medium-term outlook for the U.S. economy reflects the competing forces of private sector healing and governmental sector deterioration, leading to an expectation of modest trend growth relative to recent cycles. Household debt service burdens and financial obligations (debt service plus property taxes, lease payments, etc.) have improved substantially since peaking prior to the onset of recession, and the level of household debt outstanding relative to personal income has declined meaningfully, although the level remains elevated. The homeowner vacancy rate is at its lowest level since the housing downturn began and building activity remains well below the pace of household formation. Progress in clearing the existing stock of housing inventory and very low building activity will hasten the return to balance between supply and demand in the housing market. In addition, the average auto on the road today is quite aged relative to historic trends and should provide support for ongoing replacement demand. These are all favorable forward-looking indicators.

Source: Department of Commerce. Data through 9/30/11.
But while household sector financial balances are improving, government sector balances continue to deteriorate. The accumulation of debt outstanding by the federal government is unprecedented, with the exception of the periods of the Civil War and World Wars I and II, and has already led to a downgrade of the U.S. government’s credit rating. Without adjustment in spending and tax policies, the country’s credit standing will deteriorate further and eventually the higher costs (or restricted availability) of funding will force an end to unsustainable deficit spending. With the U.S. federal budget deficit currently running at 8.5 percent of GDP, policy adjustments needed to return to fiscal sustainability will significantly restrain overall economic growth in the coming years. The fiscal tightening process should also result in monetary policy that remains easier for longer than is generally anticipated today.

Source: International Monetary Fund, World Bank. Data through 9/30/11.

### Recovery In Corporate Earnings Has Been Robust

In contrast to the broader economy, the recovery in corporate earnings has been exceptionally robust during the past two and a half years since the recession ended. For 2011, S&P 500 Index operating earnings are likely to total around $97 per share, compared to peak earnings of roughly $92 per share prior to the downturn. The trend in profit growth has been much faster than the pace of economic growth would have suggested. This divergence can be explained by the surge in productivity growth in the early quarters of the economic recovery, a stronger recovery in foreign economic activity than in the United States and a substantial weakening in the dollar from the onset of the economic recovery. As we enter 2012, each of the trends looks to be stalling or partially reversing, and as such we’d expect a reconvergence between the performance of the economy and the corporate sector in 2012. We expect a modest pace of nominal GDP growth in the coming year, so we look for S&P 500 Index earnings to grow to only about $100 per share under the base forecast, compared to consensus views that look for earnings of better than $107 per share as of early December. The trend of negative revisions to earnings expectations should continue.
10-Year Treasury Yields Are Exceptionally Low

Ten-year Treasury yields are now below the lows reached at the height of the financial crisis in late 2008 and below levels consistent with coincident economic data. In part, the exceptionally low level of long-term Treasury yields reflects 1) a degree of global risk aversion related to the current European credit situation and 2) the Fed’s zero interest rate policy. This policy is unlikely to change for a long time. In addition, other factors have worked to push yields to today’s very low levels: 1) diminishing inflation pressures on a global basis in response to decelerating global growth, 2) foreign central banks’ easing policy and 3) the lack of aggregate credit demand, despite ballooning government budget deficits, as the private sector continues to deleverage. Yields should rise modestly in 2012 under the base forecast, but nevertheless long-term Treasury yields will likely remain very low in 2012 and probably beyond.

2012 Should Lend Itself to Tactical Allocation Strategies

The takeaway from this macroeconomic viewpoint for investment strategy is one of relatively low returns for the broad domestic asset classes, but with significant potential volatility and risk around the base forecast view. The environment in 2012 should lend itself to tactical allocation strategies, particularly given the current dynamics of financial stress and policy responses globally.

We have relatively low net exposure to both the broad domestic equity and investment grade taxable fixed income markets in our allocation strategy. The return outlook for the aggregate investment grade fixed income market is rather bleak, where the yield to maturity for the Barclays Capital Aggregate Bond Index has ranged between 2.25 and 2.50 percent in recent months. If interest rates remain steady in the coming year, investors could expect a return in this range. Given the inverse relationship likely between credit spreads and Treasury yields, it is not clear that the return outlook would be materially different under either a moderately weaker or stronger economic environment. For domestic equities, if our forecast of $100 in earnings is near the mark, the outlook will depend on the price-to-earnings (P/E) multiple the markets assign to earnings in 2012. The long-term average P/E multiple of a little better than 15 times would imply significant upside potential for equities in the coming year, but it seems quite unlikely that such a multiple will be achievable.
Extremely low long-term interest rates in the United States and across most major developed markets – at least those that are not currently experiencing sovereign credit stress – reflect low growth expectations across the developed world. Low growth in the context of the P/E to growth (PEG) ratio suggests that the P/E component of the ratio should be lower, otherwise the P/E to growth ratio would be extremely elevated. This valuation relationship appears to explain market levels across many of the developed equity markets where P/E ratios and price-to-book ratios are well below those in the United States, while dividend yields are significantly higher. The lower valuation measures in many foreign markets suggest a more attractive forward-looking view for foreign equities in aggregate. But with Europe just entering what may be a protracted recession and growth continuing to decelerate in Asia, we think it is premature to increase our allocation to these markets.

We prefer to take exposure to alternatives in the fixed income market such as select foreign markets on a currency hedged basis; municipal high yield, short-term corporate credit spreads with Treasury yield risk hedged; and moderate exposure to the domestic corporate high yield sector where spreads are currently attractive unless downside risks to the economy or the European credit markets are realized. We have benefitted in 2011 from long exposure to the 30-year Treasury sector where the appreciation from falling yields has offset weakness in the performance of riskier assets. The 30-year Treasury bond is the only segment of the yield curve that has not seen its yield fall below the lows reached during the crisis in 2008. It offers some further scope for positive returns if financial conditions worsen, but we have significantly reduced our exposure following the decline in yields in favor of other positions, such as a long dollar position relative to major foreign currencies, to hedge riskier positions in the strategy.

We have also maintained relatively low net exposure to the equity markets given their low return and high volatility profile under the current circumstances. Instead we are focusing on long and short positioning to capture return from performance differentials, such as domestic large cap outperformance of small caps and the outperformance of countries with strong credit profiles over those with weak credit profiles. We have also maintained exposure to select foreign markets and global sectors such as Russia, Switzerland, gold mines and emerging market high dividend payers to name a few. We are looking for an upturn in global leading indicators, a concrete policy response to situation in Europe or more compelling market valuations before increasing our net exposure in any meaningful way.