Few could have predicted the events that transpired in 2011. The number and magnitude of dramatic events during the year kept investment markets volatile. After such a turbulent time in the financial markets, our investment leaders look ahead and share outlooks for potential opportunities and risks in the coming year.

“It is more clear than ever that we have a globally-connected economy,” says Tim Leach, chief investment officer. “Just as the 2008 financial crisis in the U.S. was felt around the world, the same is true today. Aftershocks from other events, most notably Europe’s debt crisis, are resonating in the U.S.”

Despite all that’s happened and the array of looming threats the markets must deal with, Tim says it appears that the U.S. economy is on sound fundamental footing heading into 2012. “Growth may be modestly faster in the coming year than we experienced in 2011, although Europe remains the biggest question mark today.” Tim believes there are reasons for optimism about better opportunities elsewhere in the world and anticipates that many areas of U.S. and international markets will be positioned for improved performance in 2012. “We believe opportunities appear reasonably attractive, particularly for risk-type assets like stocks, commodities, real estate and credit securities.”
We are hopeful that a sufficient resolution to the European sovereign debt crisis can be found in 2012, though the plan may take years to be fully executed.

- The reactions to the European sovereign debt crisis are likely to leave Europe in a moderate recession for much of 2012. This recession is likely to have consequences for global economic growth.

- The European crisis, combined with the effects of recently concluded monetary tightening programs across most emerging market nations, likely means moderating economic growth for emerging market nations, such as China and India, for much of 2012. Over the course of 2012 we expect emerging market economies to react to this slowdown in growth by easing monetary policy.

- Our view is that global inflation likely eases through much of 2012, with U.S. headline inflation easing toward 2% year over year. However, inflation is likely to stabilize and increase somewhat in the latter portion of 2012. This will be in reaction to global monetary easing from developed countries as they deal with the European crisis, and in the emerging market countries as they attempt to halt slower economic growth.

- In our view, U.S. economic growth is likely to remain in the range of 1%-3% during 2012, with the continued struggles in the housing market recovery, and continued consumer deleveraging mitigating modest growth in employment and business investment.

- 2011 year-end progress in employment growth seems likely to carry through into 2012, although the rate of unemployment seems unlikely to move below 8%. Labor force growth has exceeded payroll growth in recent years and this demographic trend seems likely to persist and constrain significant improvements in unemployment.
In the quarter ahead, we are likely to see a noticeable slowdown in earnings growth for domestic equities. Exports to Europe, 14% of the S&P 500’s top line, are likely to slow as this region may be in a recession for much of 2012.

We believe that the consensus estimate for 2012 earnings for the S&P 500, currently in the $110 range, will likely drift lower as information provided with 4Q 2011 results points to headwinds from Europe. Even though we believe U.S. macro conditions are beginning to improve, our earnings estimate for 2012 is $97 due to anticipated slowdowns related to conditions in Europe, most notably over the first half of 2012.

It is our belief that equities could be aided by additional expressions of monetary accommodation from the global central banks. If the eurozone’s political leadership reaches a credible deal addressing banking capital, debt and growth in the region, these developments may also be constructive for equity prices.

“There is some optimism we can point to that may set the stage for a more productive 2012 for stocks,” says Jim Russell, head of equity strategy. Jim says investors should consider taking a closer look at equities this year. “We think stocks are very inexpensive right now. On an absolute basis, relative to history and relative to bond yields, stock valuations are attractive.” Even with the relatively flat performance in 2011, U.S. stocks as a whole outperformed most markets around the globe. “We think U.S. stocks will continue to be the choice for investors globally in 2012. I think some clarity has been brought to the table by European politicians, leading to a possible resolution of the debt crisis in that region. However, because 45% of S&P earnings come from overseas, it is clear we’re a globally-linked system,” according to Jim. “We expect some impact will be felt from Europe and from slower growth in emerging market countries like China.” Even though he believes economic conditions in the U.S. have improved, profit growth at U.S. companies may subside in 2012 due to economic challenges elsewhere in the world.
Interest rates on U.S. Treasury securities are likely to stay in a tight trading range in the early months of 2012, according to Dan Heckman, co-head of fixed income strategy. “Although rates are already low, the risk of a dramatic jump is not great. A weak job market makes it difficult for inflation to accelerate, and that should hold interest rates in check.”

Jennifer Vail, co-head of fixed income strategy, believes the market for fixed income investments is in a holding pattern. “It appears the market is waiting for resolution in the eurozone, and that accounts for the narrow trading range we’ve seen in the market.” She believes that positive economic growth in the U.S. alone will not trigger a major upturn in interest rates because the European crisis remains the focus for investors.

Looking into the first quarter of 2012, we anticipate a range bound market on U.S. Treasury interest rates, which trends lower on the longer end of the yield curve.

- Failure to effectively resolve the European debt crisis is likely to continue to force investor funds into perceived safe-haven assets like U.S. Treasuries, keeping a lid on rising interest rates.
- The Federal Reserve’s commitment to keep the Fed Funds rate at zero through mid-2013 and the implementation of Operation Twist (where the Fed sells short-term maturities and purchases longer term maturities) will likely flatten the yield curve and keep interest rates at historically low levels.

We continue to favor investment grade corporates over other taxable bond sectors. New issuance of investment grade corporate bonds has been reasonable to meet heavy investor appetite for quality assets, creating a favorable supply/demand environment.

With the new issue market opening back up, we now consider high yield to be relatively attractive heading into 2012.

The municipal bond market has continued its recent rally as state governors around the U.S. enact further spending cuts to balance budgets and endorse public employee pension reform.

- We anticipate a significant decline in new municipal bond issuance well into 2012, eventually creating a shortage of quality municipal bond offerings or supply.
- A continued fading of the “headline risk of defaults” is expected. Although economic weakness could impact defaults in 2012, we still see municipalities taking on budget shortfalls and pension reforms.
- A continuation of strong fund flows into munis should remain in 2012 as they may benefit from a flight to quality trade, along with Treasuries.
• Global growth has been moderating over the past year and this condition is likely to continue over the course of 2012. The slowing pace of growth should ease demand for many commodities, although the ongoing crisis in Europe will likely make this trade quite volatile as the market reacts, and likely overreacts, to policy driven news flow.

• As we move into the second half of 2012, the increase in global money supply from monetary easing policies in emerging market countries as well as Europe and the U.S. seeking to spur growth, will likely improve the demand condition for commodities. The relatively tight global supplies for commodities, such as oil and copper, means this increase in demand will likely be volatile for prices as the market seeks to ration supplies to the users who value them the most.

• In the oil market, the relatively over-supplied position of U.S. inventories has been depleted and inventories across the world are now below their recent five-year average. Easing global demand means that prices are not seeing excessive upward pressure, especially as Libya is able to restart oil production, which may improve the global supply position.

Rob Haworth, head of commodities strategy, anticipates that monetary easing is likely to occur across global markets in 2012, with some of that money flowing into gold. “There’s room for speculators to return to the gold market,” says Rob, “but we may not experience the mania around gold that occurred during the peak months of 2011.”
For real estate investors in 2012, Kevin Weigel, senior real estate strategist, suggests that income may be the best opportunity. 

“Investors may not want to rely on price appreciation to generate returns in this real estate environment,” says Kevin. “A monthly income strategy is likely to offer the best potential.” Kevin says the market today is a good one for lenders. “There are sectors of the market that don’t have access to capital. You can charge a lot to provide capital, more than would be indicated by the risk you are taking.” Kevin believes lending potential is available for many attractive types of properties and this may create a solid income opportunity.

• Within an anticipated setting of continued macro instability during 2012, we believe real estate will likely consist of the “haves” and the “have nots.” The “haves” are the “core” assets in top tier markets with ready access to capital. The “have nots,” which is basically everything but “core,” may essentially be cut off from the mainstream flow of capital. Investors may wish to position themselves properly in both markets to potentially optimize portfolio performance.

• If the macro economy deteriorates further, “core” real estate may be able to help buffer portfolio volatility by potentially providing stable income and relatively stable pricing. “Core” real estate may be among the safest places to ride out any storm in 2012.

• The residential market will likely continue to be sluggish. We believe government programs designed to help underwater borrowers will be relatively ineffective and will help too few to move the market. Significant shadow inventory still exists and at current liquidation rates, the pipeline of distressed inventory may take years to clear. We do not expect housing to be accretive to GDP for some time.

• REITs (Real Estate Investment Trusts) currently trade at a 15% premium to private core equity and face more downside price risk than the private market. We expect the price gap to narrow over time.

• REITs may very well outperform the broader equity market as investors flock to the higher dividend yield potential available in REITs.

• Non-core assets (less than 90% lease stabilized) will likely languish in all but the best locations nationally. Achieving full lease levels has been slower than expected. In the absence of more robust Gross Domestic Product (GDP) and employment growth, this trend will likely continue.
If you have questions regarding this information or wish to receive definitions of any of the terms used in this commentary, please contact your Wealth Management Advisor.