Market Perspectives

A Glance At How The World Affects You!

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Registered Investment Advisor

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Closing 2011 and Navigating 2012…..

We can finally close the books on what turned out to be a very challenging year filled with volatility. No one can dispute that 2011 was a conundrum of sorts and much of that puzzle remains to be solved. Even the die-hard bulls were ready to throw in the towel as we headed into the final trading days of the year. Trading volume remained weak as traders tried to figure out how to position their portfolio allocations for the New Year.

Domestic stock market returns were below normal for 2011 - the NASDAQ composite was (-3.24%), the S&P 500 (-1.14%) and the Dow Jones Industrial Average (+4.74%). While these returns were below average, they far outpaced returns from global equities. Even so, bullish investors are prognosticating a positive 2012 based on encouraging trends in domestic economic data and “more hope” that Europe can solve its sovereign debt crisis which continues to linger. Despite the prevailing bullish trend, the Bull/Bear index appears to be just a little bit ahead of itself as we have watched it move quickly to a 60% reading from a mid-year 30% reading.

Looking into the New Year, there are a few reasons to be optimistic. Analysts are now expecting the economy to advance (on average) by 2.6% in 2012, which is up from the previously anticipated 1.9%. The improvement

is supported by several assumptions. First, unemployment claims have been improving. A year ago, claims averaged 453,000 per week. The weekly average is now below 400,000; which is still higher than we would like, but that may be due to short term seasonal hires. Second, while companies remain loath to hire, they are continuing to spend on equipment and technology, which drives production. Third, low inventory to sales ratios seem to imply that companies will continue to restock; this should boost industrials. Finally, the greenback has been gaining strength amid the European crisis. However, we believe that is a fleeting trend that will give way to ongoing political instability in Washington and ridiculously low interest rates. As the dollar reverses trend, U.S. goods will be more attractively priced for foreign economies that continue to grow.

Looking ahead, as the bulls are anticipating big returns in the coming year, we should consider the possibility of too much optimism in the aforementioned. At least on a preliminary basis, some caution is advised before you bet the farm. The risk of a recession is low, but not out of the question. The recent ISM index (a measure of business confidence) has been hovering at the break-even level. We mentioned that unemployment claims have averaged below 400,000; should the economy’s job base start to shrink, odds of a recession will grow rapidly. Lest we forget, the consumer makes up 62% of GDP, and they need jobs to continue spending. Last Thursday’s weekly jobless claims moved in the wrong direction following several weeks of improvement. That is a possible indicator that much of the improvement was due to seasonal hires.

Other risks for 2012 include the political climate in Washington. It just wouldn’t be right if we didn’t mention hackneyed politicians who continue their banal and unsuccessful attempts at leadership. The so-called Super Committee of budget cutters ignored their responsibility. Rather than focusing on spending cuts in this no-growth economy, perhaps their attention should be on creating more jobs.

As we turn the corner and start the New Year, current dollar strength will bring some pretty strong headwinds. The Euro’s strength continues to decline and, at least technically speaking, lower highs and lower lows are signaling further decline. Because of this, we anticipate a 5% to 10% correction in stock prices during the first half of next year as the greenback gains strength and technical indicators signal overbought conditions.

The Bottom Line: With so much consternation and global uncertainty, even the pros have come up short in 2011. What can you expect in 2012? On the whole, we see stocks undervalued relative to fair value. In spite of this, investors should remain circumspect when making decisions about which stocks to purchase and how much. Adding to the complexity of an already vexing global economy, we don't expect Europe to go away as a market mover in 2012; get prepared for more volatility.

Assuming that the U.S. can continue to generate a positive economic environment and real estate bumps into positive territory, compared to 2011, the stock market can easily move higher. I mention real estate with some trepidation, but at least multi-family units are in demand as the newly "un-housed" become renters once more. Even a fraction of growth in this sector means jobs and GDP growth.

Our outlook on the financial sector remains bleak as shadow inventory and slow lending continues to weigh on profitability. For that reason, our allocation to financials is significantly underweight. Throughout the New Year, all eyes will be on the consumer, jobs, Washington and global growth. Consumer confidence climbed to 56.0 in November, up from a dismal reading of 40.0 in October. Even so, actions will speak louder than words.

Extreme volatility over the last several months continues to weigh on virtually all portfolios, and I fully expect that movement into the first half of 2012. However, stocks remain attractively valued compared to historical valuations and bonds. The potential for relative outperformance for stocks through 2012 remains intact. Based on earnings trends, which remain positive (but are decelerating); low interest rates; and an expected downtrend in the dollar, investors will be driven towards riskier assets once the panic surrounding the European debt crisis subsides.

In the short term, we expect domestic equities to remain under pressure; at least for the next two quarters. Recent easing (lowering of interest rates) in China should support global stocks as emerging economies continue to grow. On a technical basis, the recent rally is looking tired, but euphoria could easily drive this market higher before the inevitable reversal.

Best Regards,
Phillip L. Clark, RFC
President/CEO

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