



Economic and Market Overview – Fourth Quarter, 2011

By Bryon Wall, Vice President, ERISA and Investment Consulting, Stable Two Financial, LLC

Prepared January, 2012

For all its sound and fury US equities, remarkably, finished the year flat. Most foreign equity markets finished down and in the case of China, markedly so. For the most part, the eyes of the world were focused on events in Europe where the outcomes have global implications. For the moment the ECB seems to have purchased leaders some time with a three year lending facility. There is no doubt that barring this extension of credit, major financial institutions would have made remarkably colorful and unpleasant headlines. Economic news in the US was generally positive however, and while most of the global economy is flashing recession the US continues on the course of slow growth. Given continued uncertainty, heightened levels of volatility are very likely in Q1 of 2012.

High level overview

- ▶ Q4 European concerns continue to dominate investment climate
- ▶ Domestic Equity
 - Fourth quarter trailing data suggests the economy continues on a slow growth trajectory
 - Markets whipsawed on European headlines
 - Concerns over debt ceiling took back stage as Republican primaries and Occupy movements dominated domestic news. A temporary budget agreement was eventually reached before year end
 - Capital spending remained strong but as favorable tax treatment on capital investments expires Q1 2012 could see a weakening in this trend
 - Corporate earnings remained largely positive
- ▶ International
 - Europe dominates
 - Managed Greek default agreed to but not called a default
 - Contagion spreads to Spain and Italy, French rating cut a real possibility
 - Capital flight from European banks stemmed by three year lending facility from ECB
 - Solutions / Outcomes still developing but large portions of Europe appears to be slipping into recession
 - Lending facility a key factor in buying time
 - China Real Estate appears to continue its deterioration
 - Dramatically slower growth in manufacturing
 - Signals of easing but no rate cuts (yet)
 - New leadership coming in 2012 bears watching
 - Chinese markets have discounted a slow down as have many commodity driven emerging economies
- ▶ Interest rates and Treasury yields
 - Safe haven buying, particularly given concerns over the Euro continues
 - Rates continue to remain low given flight from risk
 - No changes in Fed policy on the horizon
 - Dollar the favored currency as gold positions are liquidated and investors flee the Euro

Market Specific Details

United States

Economic signals in Q4 2011 were generally positive but as we have mentioned previously, companies were incentivized to front load capital spending. As we move into 2012 it will be necessary to watch for signs of slowing. Already the Federal Reserve minutes suggest we may see another round of quantitative easing in 2012. Prior easing has been generally positive for investors and it is likely to again be the case if indeed it occurs. The results on the general economy however are much more debatable. The yield curve continues to be very flat as investors have fled risk. While the rate of unemployment, as measured, declined it is still uncomfortably high by historic measures. And while the tone of this summary waxes caution there are real reasons to be optimistic. The US is experiencing a boom in energy production. Housing appears to have stabilized and my daughter has found a job (no small accomplishment). The dollar has reversed a long term down trend and caution around the Euro as a reserve currency may allow this trend to persist at least until we are offered another round of "easing."

Europe

Europe continues to drive global volatility as the leaders of various institutions announce agreements to agree, with marginal details to be determined later. Greece was permitted to default on a "voluntary" basis and it is very possible to see this "voluntary" reduction reduced still further in Q1 2012. Greece has large payments due in March and does not have the cash. At this time there is no clear solution on the horizon. The ECB has, however, bought time with a three year lending facility to banks which in all probability averted the bank runs which were beginning to take place. To our thinking this is a stealthy version of printing Euro's in an attempt to paper the problem over. This will work until it doesn't but in the meantime a true fiscal union still appears unlikely. A treaty revision is in the works but it is unclear whether this will actually pass or what it may really accomplish beyond more of the same austerity which has not been working for any of the countries desperately trying to balance their budgets as they slide into recession. Further "voluntary" adjustments remain a real probability.

The situation continues to develop and the systemic issues must eventually be addressed. Long term investors, however, will likely be rewarded by selectively purchasing companies with strong balance sheets and products which are globally consumed or locally necessary.

China

Evidence that China is experiencing a bursting property bubble only increased in Q4 2011. According to some agencies, builders have 22 months of unsold supply in Beijing and prices dropped 35% in November alone (1). While many analysts still believe that China will manage a "soft" landing, there is some discussion around the possibility of a hard landing. As Chinese leadership changes, it is difficult to handicap the likely responses. A soft global economy will hamper China's ability to export their way out of a recession but given that China is a command economy it is possible that they take efforts to mitigate declining property prices and could even reverse course with another dictated building boom. This is a counter intuitive move but it can't be ruled out. In point of fact we fully expect China will support its banking institutions much as they always have. The bad debt will magically find itself not reflected in the bank balance sheets. The same assurance cannot be given for the non official lending. The true extent of the non official lending is not known nor is it entirely clear what will happen when this debt goes "bad." Chinese leaders are describing 2012 as "unpredictable, complicated, grim and difficult" (2).

For the moment China has only marginally begun to ease and for the moment leadership seems willing to permit a decline in property prices. This is the Chinese way of moderating inflation and the Chinese stock markets appear to have discounted a significant slowing of growth. Once rumors of easing become prevalent investors can expect Chinese equities to reverse course but as previously suggested, the situation bears close watching. Chinese policy will ripple across the globe and particularly in commodity based emerging economies many of which have already reflected China's slowing.

Interest rates

The fourth quarter saw continued safe haven buying of Treasuries, Fed policy to hold near term rates at zero, and "operation twist." This resulted in incredibly low rates and a stronger dollar.

Should global outlooks stabilize or if the Federal Reserve announces another round of easing, we could see reversal of flows and higher intermediate rates. We do not believe rates will move significantly higher over the next several quarters but another round of easing would probably prove positive for equities and some commodities.

Summary

China bears close watching and events in Europe will continue to whipsaw markets. The ECB has bought European leaders some time but it is unclear whether this will be used wisely. Global markets have been discounting contraction except in the US where equities have swung in a wide yet ultimately flat range. Unmanaged default in Europe seems less likely and some have speculated that the ECB facility could be a back door way of lowering rates or even ultimately permitting a member nation to depart from the Union. For the moment this doesn't appear imminent but further "voluntary" restructures remain a high probability in 2012.

Economic stimulus appears unlikely in Europe but the Federal Reserve has flashed a signal that further easing may occur as early as the first quarter of 2012. Politically it is unlikely that Congress will do much more than continue to posture in this election year. China will probably ease monetary policy in 2012 in some way but the extent and timing are still very unclear.

The resurgent dollar could persist but further easing and risk aversion could change this trend. This may translate into higher rates than the recent lows but we do not expect rates to run significantly higher than what we saw in 2011. Commodity prices have moderated somewhat but oil and some food items have not due to political tensions and drought.

1. Chovanec, Patrick. "China's Real Estate Bubble May Have Just Popped." Foreign Affairs (18 Dec 2011) < <http://www.foreignaffairs.com/articles/136963/patrick-chovanec/chinas-real-estate-bubble-may-have-just-popped> >.
2. Wei Jianguo, secretary general, Center for International Economic Exchanges, as reported 12/25/11 on soberlook.com, < <http://soberlook.com/2011/12/correction-in-chinas-property-markets.html> >.

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