January 2012

2011 was a year of transition. While the change in the markets from the beginning of the year to the end of the year was not dramatic, the fluctuations during the year were quite attention grabbing. The S&P500 index hit a high of 1363.61 and a low of 1123.95 during the year. For the year, the index moved 0%. Almost a 240 point spread with no change as a result. After starting the year at 1257, the S&P500 moved up over 8% by May to 1363, then fell over 17% down to 1123 by the beginning of October. The year- end rally got us back to break-even.

Globally, things did not play out as well. According to a Financial Times article, almost $6.3 trillion was “erased from global stock markets” during 2011. I should note that the 0% S&P return figure does not include dividends received. In light of what transpired around the globe, 0% plus dividends is a good result.

While it is always dangerous to make a prediction in writing, I will do so. I expect to see a similar amount of volatility this year, but I expect to see higher lows and higher highs as the markets fluctuate up and down. I do expect to see positive returns for the equity markets this year.

Market returns depend on earnings growth and the price earnings multiple of the market. I expect to see earnings up a little, but a slight PE multiple expansion from today’s level that will result in 10% equity returns this year give or take a couple of percent.

What will cause the volatility? The transition in North Korea could cause some disruptions in market confidence. Iran could cause problems for the energy markets. Europe is still at the beginning stage of dealing with their debt problem. While some action has been taken (and the ability for the leadership to take some action has created some increased confidence in markets), there is a long way to go, and I am sure it will not all be smooth sailing. There is a real estate bubble that is deflating in China right now. If their economy is weaker than is currently expected, it could cause weakness in risk markets globally. Finally, recent strength in our economy was supported by people reducing their savings rates. This is an unsustainable source of growth. We need to see some employment growth to support higher incomes.

As stated earlier, 2011 was a year of transition. Much of the developed world experienced a debt binge during the 2000’s. We are now making adjustments to that reality, and these adjustments will take time. Here in America, we have been at this for a few years. We were in crisis mode for a while, and then the private sector got back to work, and a fair amount of debt was shifted to the government books. Our next step is to address the government’s debt, and to make sure that our economy continues to grow and create sustainable jobs. Europe is currently in crisis mode. They will work out of this mode, and they too will get back to work.

Anytime you decide to reduce leverage, economic growth suffers. When you borrow and spend the proceeds, it boosts economic growth. When you have to use some of your resources to pay down debt, your spending or saving will decline, and economic growth will be slower than otherwise. We know then that economic growth will be slower than normal in Europe and America.

Fortunately, many of the economies in Europe are impacted by high levels of corruption and inefficient and onerous government regulation. Economic growth can be boosted in these countries through reforms, which a number of countries are now trying to implement. If done successfully, Europe in general has a chance to deal with its debt while experiencing slow but positive growth. Policy choices are critical for allowing this to happen.

When in crisis mode, the PE of the market can fall to quite low levels. We saw this in the U.S. during the fall of 2008 and the spring of 2009. We saw this last year in Europe. When you exit crisis mode, the PE multiple can increase, but will likely stay low due to the low expectations for economic growth (given that we are paying down debt). As Europe continues to exit crisis mode, I can see the PE of the market creeping up a bit. Again, this will not be an even process, but one defined by cycles with higher lows and higher highs than 2011.

A key assumption to my expectations for 2012 is that we will get leaders in Washington who are more fiscally responsible than the current ones. I heard someone mention recently that we are bound to protect Taiwan if China moves against them, but we would probably have to borrow money from China in order to do so. We simply cannot continue to spend and borrow at current rates. Thank goodness Europe is such a mess. That gives us time before the world begins to look at our books too closely.

We also need leadership that is more constructive to business and wealth creation. Since businesses hire people, and government raises tax revenue from created wealth, I would not think this would be so difficult.

It is an election year, so I assume there will be much noise about how bad everyone and everything is from all sides. There will be lurching progress in Europe. I expect companies will keep their heads down and continue trying to provide their goods and services to their customers. As I said before, I expect all of this to result in moderate stock market gains this year. We shall see.

Sincerely,

Peter B. Harre, CFA