OVERVIEW

Economic Analysis and Market Review

Q4 — 2011

What went wrong? The third year of a presidential term is supposed to be good for the economy (and the stock market) as the current administration does everything in its power to pump it up and prepare for the coming election. The 4-year "Presidential Cycle" has usually been reliable for economic forecasters and market timers. Not so in 2011. The administration certainly did its job by keeping interest rates at historic lows. This should have encouraged companies to borrow to build and expand and families to buy homes with 4% mortgages. But things haven't worked out the way the planners planned. Corporations are sitting on a cash hoard of over $2 Trillion and that doesn't appear to be changing. You can "stimulate" all you want but if businesses cannot see a reason to spend money to turn a profit, they won't. Similarly, if banks cannot see a reason to lend with reasonable security that loans will be repaid, they won't. Consumer demand needs to pick up before businesses will start to expand. Consumers are spending more but more slowly than normal. More of the consumers' discretionary income is being diverted to debt repayment—in other words, paying for past purchases. Consumer demand will pick up when the job market improves and that is just now beginning to happen. One of the primary engines for job growth is small business and one of the signs that small businesses are feeling better is the sales growth of the Ford F-series of trucks. Small business owners are the biggest buyers of Ford trucks and Ford sold more F-series trucks in December than they have since 2006. There are other signs of an improving economy in the U.S.: railcar loadings hit new all-time highs recently, credit card delinquencies have plunged to record lows, the regional purchasing managers' index is stronger, pending home sales are improving, job surveys are better and unemployment claims are falling. Things look promising , what could go wrong?

Well, in a word, Europe. The Euro-zone matters. Its financial system is larger than ours. Its population is larger and its economy is almost as large as ours and China's combined. If there is a financial crisis involving European banks, it will most certainly affect our financial markets in 2012.

2011 was a very difficult year. German Chancellor Angela Merkel believes that 2012 “will no doubt be more difficult than 2011”. Chancellor Merkel has become the most important politician in Europe and generally, one of the most optimistic public figures in Europe throughout this debt crisis. Europe’s deficits and debt are at the heart of the current crisis.

When the European Union was created, complete financial integration was not part of the package. The 17 countries that make up the Euro-zone adopted a common currency and outsourced monetary policy to a common central bank (ECB). But unlike our central bank, the Fed, the ECB rejects the role of the lender of last resort so bailouts require a unanimous vote of the European Union. Getting the politicians of 17 sovereign countries to agree on something is difficult at best . This crisis has revealed the flaws in the European Union—a common currency but different debt levels, interest rates, budget deficits, labor market rules and tax policies. Given the severity of the crisis, the fate of the Euro is in doubt. The Council on Foreign Relations said in its report “The euro should now be recognized as an experiment that failed. This failure, which has come after just over a dozen years since the euro was introduced, in 1999, was not an accident or the result of bureaucratic mismanagement but rather the inevitable consequence of imposing a single currency on a very heterogeneous group of countries. The adverse economic consequences of the euro include the sovereign debt crises in several European countries, the fragile condition of major European banks, high levels of unemployment across the Euro—zone and the large trade deficits that now plague most Euro-zone countries.”

Credit Suisse’s Fixed Income Research unit said in one of their reports “We seem to have entered the last days of the euro as we currently know it. That doesn’t make a breakup very likely, but it does mean some extraordinary things will almost certainly need to happen—probably by mid-January—to prevent the progressive closure of all the euro zone sovereign bond markets, potentially accompanied by escalating runs on even the strongest banks.” The European debt crisis just continues to get worse and worse. None of the solutions that European leaders have tried have worked. We are rapidly approaching what might be called the meltdown phase of this crisis.

The ultimate effect the financial crisis in Europe will have on global markets is unknown but it will have a severe impact. Global markets face as much risk now as they did in 2008. According to Noralyn Marshall of Risk Management Advisors, LLC, in December,” global central banks stepped in to lower dollar borrowing costs for Euro-zone banks. Next, the ECB is expected to help by cutting interest rates. This temporarily helps ease the bank funding crisis but does not get to the heart of the sovereign debt problem. Now Standard &Poor’s has included Germany in the list of countries considered for a downgrade, adding bunds to the “risky asset” class.”

The uncertainty coming from the Euro-zone had a profound effect on our markets in 2011. Many experienced fund managers called the stock market a "casino" as fundamental analysis became almost irrelevant. According to Michael Murphy, CEO of hedge fund Rosecliff Capital, "The very analysis that hedge funds rely on has become secondary to the headlines coming out of Europe on a daily basis." And diversification in a portfolio became meaningless as all asset classes traded in tandem.

So earnings, growth, interest rates? None of that matters as Europe totters on the brink. And we won't know what does matter until trading in the new year unfolds.

INDEX	Q4'11	YTD
S&P 500	11.82%	2.11%
Russell 2000	15.47%	-4.18%
Europe, Aust., Far East	3.33%	-12.14%
Barclays Agg. Bond	1.18%	8.74%
Wilshire Real Estate	15.36%	9.37%
Treasury Bills	0.00%	0.10%

- The S&P 500 is an index of 500 large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of the developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- Wilshire Real Estate Index is an index of commercial real estate properties