

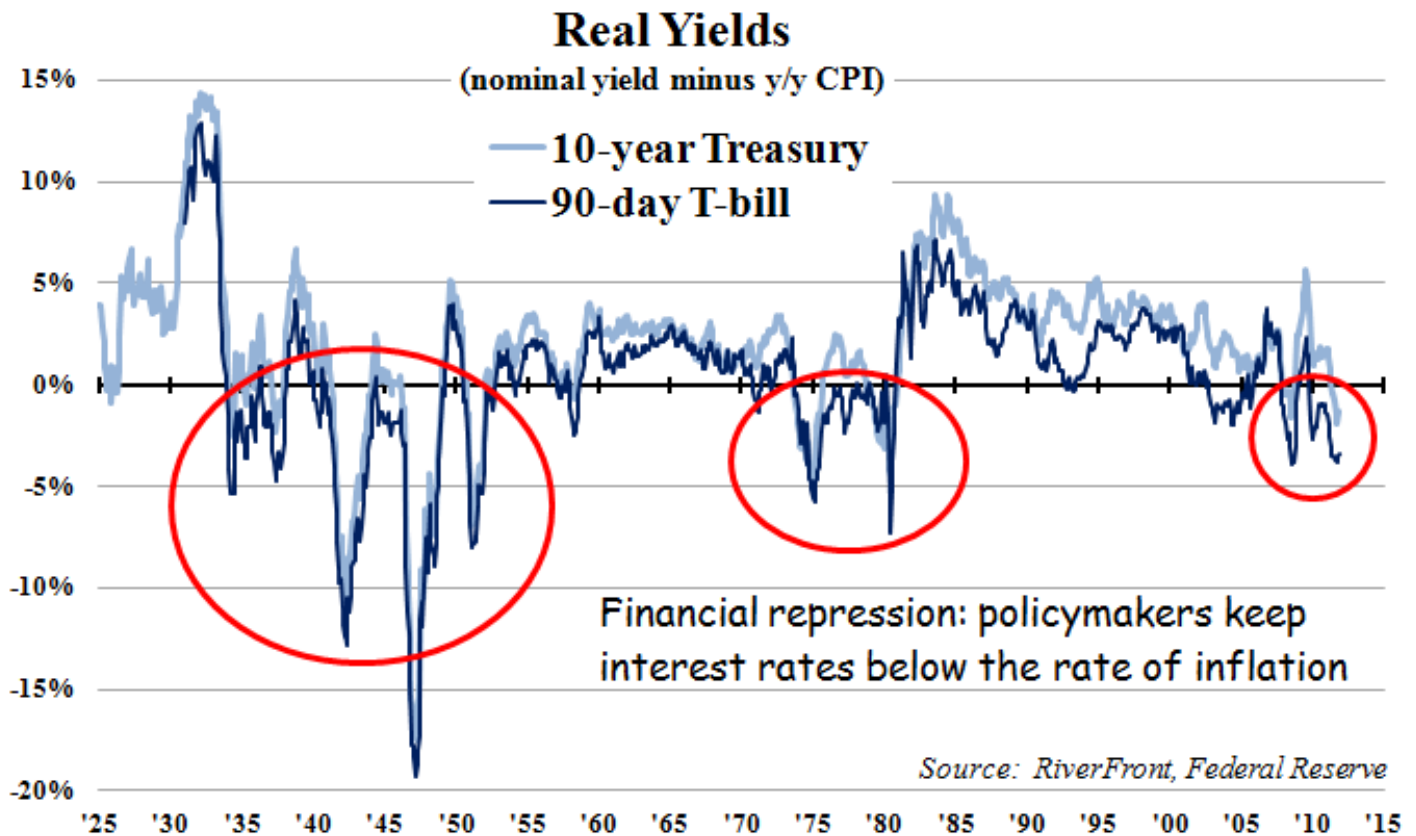


# Outlook 2012: Navigating Policy Purgatory

## Highlights

- **The Economy: Policy Purgatory.** Policymakers of the world's major economies have largely failed to address long-term global imbalances, opting instead to continue 'buying time' through short-term measures. Thus our 2012 outlook remains dependent upon the political maneuvering and resulting policies in Europe, China and the US. Overall economic growth is likely to decline due to renewed recession in Europe, but improving conditions in developing economies and the US should help avoid global recession.
- **Fixed Income: Continued High Volatility and Financial Repression.** We believe that the high fixed income market volatility during the second half of 2011 will continue into 2012 because of unresolved problems and concerns. European countries and banks must roll over large amounts of maturing debt during 2012, which will likely pose serious challenges. The prospects for a pick-up in global growth, which could help ease debt burdens, is dependent on developments in three major regions: Europe, China/emerging markets, and the US. Furthermore, the Fed has announced its intention to hold rates near 0% until at least 2013. This means that shorter-term CD and Treasury holdings will continue to suffer meaningful losses in purchasing power.
- **Fixed Income Strategies for 2012:** Focus on fixed income sectors with the ability to deliver positive inflation-adjusted returns; favor corporate and emerging market credit risk over developed sovereign risk; provide a measure of portfolio price stability while avoiding undo interest rate risk.
- **Global Stocks: Earnings growth will slow but global policy easing may allow stocks to rise.** We believe 2012 will be a year of concurrent global monetary easing, the first since 2009/10. We believe China avoids a hard landing but does not avoid a painful property and bad debt cycle and is forced to use substantial government resources to restructure the debt. We see a relatively strong US dollar rising against the Euro during the year. We think commodity prices, especially oil, agriculture and gold, respond positively to both monetary easing and the anticipation of stronger growth in the developing world in the second half of 2012 and into 2013.
- We see a wide trading range again for the S&P 500 of 1140 to 1440. We think the US market continues to lead in the first half of 2012, but that at some point, emerging markets will have discounted the growth slowdown and will start to anticipate a revival. Europe become attractive to us if the euro falls enough to improve the competitiveness of stronger Northern European countries like Germany, but during that process the Eurozone will likely underperform. Within Europe, we like the UK because of the market's composition of high quality global franchise businesses, above average dividends and below average PE's. We begin 2012 heavily underweight continental Europe and while the year will likely offer trading opportunities, we are currently somewhat defensive overall.
- Our favorite sectors include Healthcare and Technology, which we think have better growth prospects, superior relative strength and better valuations than the broad market; and Consumer Discretionary, which is valued in line with the broad market but has better growth prospects and relative strength. Although the growth prospects for our universe of dividend paying stocks are somewhat less than the broad market, we think their attractive valuation and superior relative strength will help them outperform in an environment of high market volatility and below trend economic growth.

## The Weekly Chart: Financial repression penalizes savers



We see continued purchasing power erosion (Financial Repression). Short-term interest rates are now entering their fourth consecutive year at well below the rate of inflation, as the Federal Reserve has kept short-term rates pegged near 0% since December 2008. Furthermore, the Fed has announced their intention to hold rates near 0% until at least 2013. This means that shorter-term CD and Treasury holdings will continue to suffer meaningful losses in purchasing power. The entire Treasury yield curve is currently below headline inflation of 3.6%, as the Fed's 'operation twist' — purchasing \$400 billion of longer-term Treasuries and selling a like amount of shorter-term securities (by June 2012) — contributed to a sharp drop in longer-term yields during the second half of 2011. By keeping interest rates at historically low levels, the Fed is helping to ease the US government's interest burden on its huge debt outstanding (\$14.3 trillion). The chart (financial repression) on the next page shows the 3-month Treasury bill rate and the 10-year Treasury bond yield, after inflation.

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