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Market Commentary

A Review of the Markets and a Look into the Future

The Late Stage of Empire

"*The budget should be balanced, the Treasury should be refilled, public debt should be reduced, the arrogance of officialdom should be tempered and controlled, and the assistance to foreign lands should be curtailed lest Rome become bankrupt. People must again learn to work, instead of living on public assistance* ." - Cicero, 55 BC

Overview: Learning from history

Pondering the quote above, I am struck by how applicable it is to our current situation in the U.S., two millennia after it was originally uttered! Many commentators have compared America's situation to that of Rome in its decline, with up-and-coming nations like China playing the role of Visigoths clamoring at the gates.

It is certain that we, like the ancient Romans, live in an unsettled world. In terms of investments, 2011 was a tough year for finding returns. At Green Investment Management, our performance was hampered by the global nature of many of our allocations. Such holdings were generally outperformed by domestic stocks and Treasuries as investors retreated from risk.

What does this mean going forward? In 2012, should we turn back the clock, stuff our portfolios with domestic stocks and bonds like our fathers did, and pretend the rest of the world doesn't exist?

Let's use the lens of history, particularly that of ancient Rome, to try to get some perspective on this question.

Economy: Upstarts will be served

"Ancient Rome declined because it had a Senate, now what's going to happen to us with both a House and a Senate?"

- Will Rogers

Twenty-eleven was a lackluster year for the global economy, thanks to political gridlock in the U.S., a European sovereign-debt crisis that won't die and overheated emerging economies being brought in for a landing.

In the U.S. things at least finished strong, with December data generally more positive than expected, led by unemployment which fell to 8.5% as new jobless claims hit a three-year low. Fears of a double dip recession continue receding, but growth expectations remain modest for 2012. A slower-than-normal recovery is likely to continue. Goldman Sachs forecasts 2012 U.S. economic growth of 2.5%.

The bright spots of 2012 include November elections that may break political gridlock and bring long term action on debt and deficits. And if the housing market finally turns up, as some expect, it may become a new driver of growth.

Globally, economic growth is also expected to be on the slow side in 2012, with Goldman Sachs forecasting 4% overall. A big concern remains the EU sovereign debt crisis. A credible, decisive plan has yet to be implemented. But the new European Central Bank (ECB) President Mario Draghi does appear committed to doing whatever is necessary to save the economic and monetary union (see the timeline below for more information on how this union came to be). ECB has made available 3-year loans to EU banks needing liquidity. Some banks are taking these 1% loans and buying sovereign debt paying as much as 6%. One effect of this is to place the entire EU more in harm's way of any default by the troubled periphery nations such as Greece. That may seem foolhardy, but it also makes default of any EU members less palatable for all and therefore less likely. It increasingly seems like this problem is ultimately going to be solved with a combination of austerity by the profligate nations and printing of Euros by the central authority – thus some degree of shared sacrifice.

The Federal Reserve is also helping by making de-facto loans to European Banks through a "liquidity swap arrangement" with the ECB. The Federal Reserve trades dollars to the ECB in exchange for Euros. The ECB can then loan the dollars to European banks needing them for foreign transactions. This maneuver allows the ECB to make more loans to EU banks without flooding the European market with Euros and facing charges of reckless money printing. The complexity of the agreement also gives the Federal Reserve political cover from the charge it is helping bail out the EU.

We expect these and other steps will eventually convince markets that the EU is not going to collapse and become a contagion. This could become clearer in the first half of 2012, removing a major roadblock to economic progress. Nonetheless, dealing with the hangover of the crisis will continue, especially in the EU, which may already be in recession, and where austerity measures will weigh down growth prospects for the foreseeable future.

In the emerging world, policy-makers battled inflation by applying the economic brakes. This brought growth rates quickly down to earth. The worry is that they may have succeeded too well, but so far we think the landing appears soft enough. The resulting lower interest rates should help nations like China stimulate domestic demand. This is exactly what is needed to re-start growth along a more sustainable path.

European Union: A timeline

1945: World War II ends. With the continent once again devastated by war, interest in creating a more united Europe as a way to avoid future armed conflicts grows.

1951: The Treaty of Paris is signed by West Germany, France, Italy, the Netherlands, Belgium and Luxembourg. It provides for a common management of national coal and steel industries, those critical to making war.

1958 The Treaty of Rome creates a European Economic Community (EEC), a common market in which people, goods and services should be able to move freely across borders.

1968: Customs integration is achieved in the EEC, with no duties on internal trade, and identical duties on imports from outside.

1972: EEC members agree to an Exchange Rate Mechanism, a plan to let their currencies fluctuate against each other only within narrow ranges. It is an early step toward a common currency.

1979: Citizens of EEC member nations vote to elect representatives to a European Parliament.

1991: The fall of the Soviet Union opens the door to expansion into the eastern half of Europe.

1992: The Maastricht Treaty sets rules for a single European currency. In addition, the EEC will now officially be known as the European Union (EU).

1999: The Euro is introduced for commercial and financial transactions, but no physical currency exists yet. UK, Denmark and Sweden have opted out.

2002: Euro currency (notes and coins) enters circulation.

2004: A European Constitution is established. It must be ratified by referendum in all 25 member countries. After failing in France and the Netherlands, EU leaders declare a “period of reflection”.

2012: The EU now includes 27 member nations as it battles the sovereign debt crisis.

Stocks: Favoring U.S. and Emerging Nations in 2012

“Rome was not built in one day.”

-John Heywood

Twenty-eleven was not a great year for equities. The U.S. outperformed most global markets, but returns were relatively bland. The higher end of capitalization did best (see Figure 1 to the right), with the Dow Jones Industrial Average (DJIA) managing 8.4% total return for the year. Things declined moving down the cap-spectrum, with S&P 500 total return of only 2.1%. Global uncertainty, via Europe and the emerging world, was the primary culprit.

It was a classic flight to quality. Corporate earnings growth did not seem to count for much as risk aversion by investors moved into the driver’s seat. This was a marked change from 2009 and 2010, when risk appetites were on the rise.

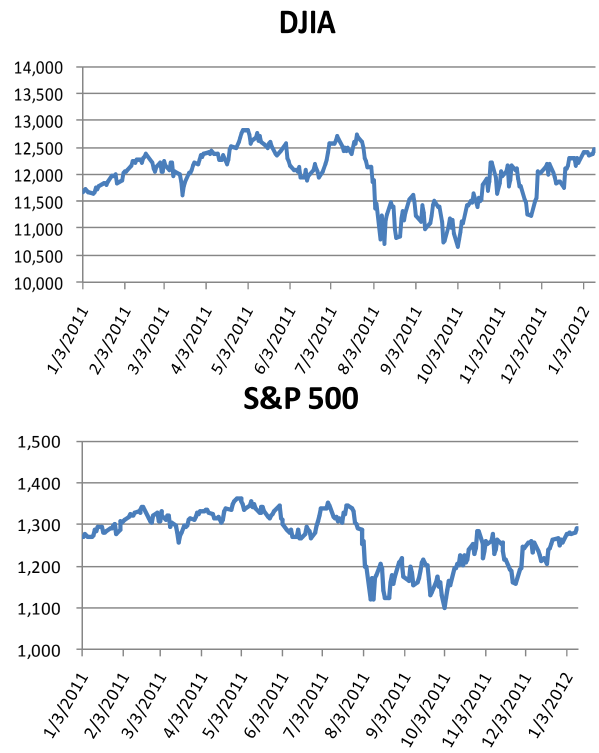

Figure 1. Blue Chips Lead in 2011. DJIA and S&P 500 in 2011 and early 2012 (adjusted daily close, source: Yahoo! Finance)

With corporate balance sheets and earnings expected to stay strong, and the prospect of a double dip recession in the U.S. unlikely, we expect returns for domestic equity to improve in 2012. The key will be for investors to realize that Europe is not going to implode and that China will restart growth sans inflation. We think the most likely scenario is volatility early in the year as these issues are watched, followed by market strength as investors gain confidence that the problems are being dealt with successfully. We look for small to mid-caps to outperform, playing catch up from 2011.

European markets faced a serious correction in 2011. Recovery will likely have to await EU meetings in March to hammer out details on the latest sovereign debt plan. The inability of authorities to decisively reassure investors thus far leads us to conclude that while an implosion of the EU is unlikely, we do not favor the region’s equities for 2012. The risk remains too high.

China is a different story. Though equities had a rough 2011, we believe prospects are good for 2012. Unless an overvalued housing sector collapses, which we do not anticipate, strong economic growth should return in 2012. Goldman Sachs predicts 8% GDP growth for the year.

China maintains deep foreign reserves, a stronger debt position and demographic advantages over the developed world. Most of the emerging nations share these advantages and they create policy flexibility going forward that the developed world will not have. By 2025, Germany, France and Italy will have non-working populations almost equal to those working. The full implications of these changes are not yet understood. But the youth of the emerging world bodes well for its long term growth potential. As with any disciplined investment strategy, patience is required. Rome was not built in a day.

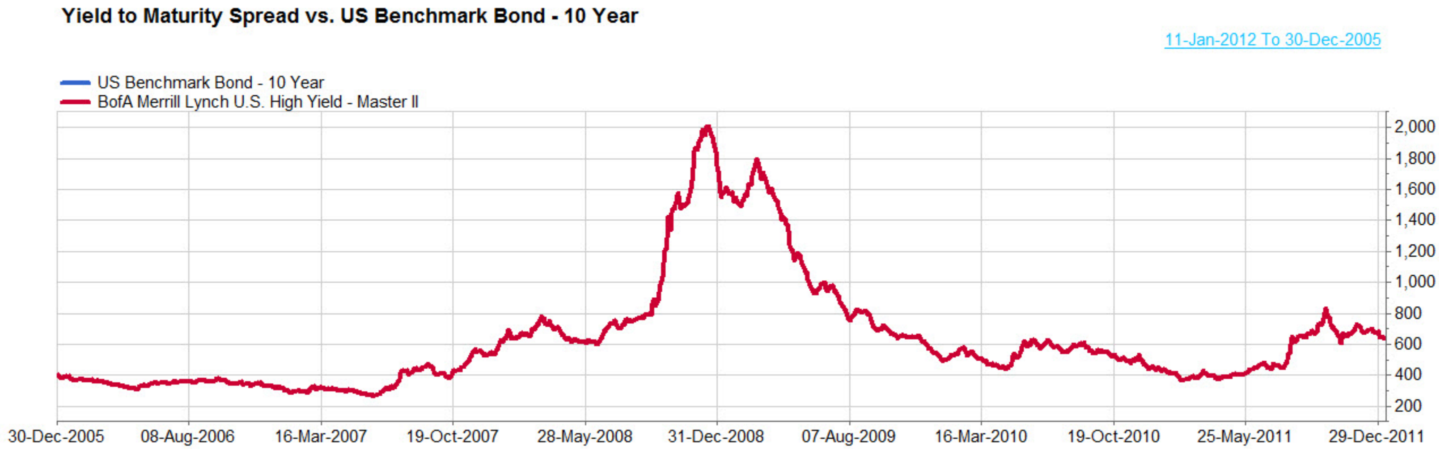

Figure 2. The credit spread between Treasuries and high yields widens again

Bonds and Interest Rates: Expect a return to risk

"Ancient Rome was as confident of the immutability of its world… as we are today."

-Arthur Erickson

The Federal Reserve is expected to keep interest rates low through mid-2013. Additional monetary easing is also possible between now and then, most likely by mid-2012. Everything will depend on the strength of the recovery. If it picks up faster than expected, with unemployment falling rapidly, the Federal Reserve's timetable could change.

Bond markets followed the pattern of equities in 2011. Investors shied from risk and favored quality. Treasuries had a strong year. But if improving economic news leads to greater risk appetites, which we expect, money that flowed to Treasuries in 2011 will flow right back out in 2012.

Municipals did well in 2011. The nightmare scenario of widespread defaults did not occur. Sales and income tax revenue improved, and we feel municipals still offer good opportunities in 2012. Due to continued risk, we look primarily to the high quality end of the spectrum.

Tepid returns to high yield corporate bonds in 2011 has not turned us off to them. Actually, the slow nature of the economic recovery that led the spread to widen in 2011 (see Figure 2 above) actually keeps them on our preferred list for 2012, because it keeps coupon payments attractive. We also expect strong corporate balance sheets and profitability to keep default rates low.

The Dollar and Commodities: All about global growth

"For a century longer, Rome still retains its outward form, but the swarming nations are now in full career."

-John Lothrop Motley

The quote above could definitely apply to our world, where the upstart, emerging nations have become the primary drivers of commodities markets. Other than energy, commodities had a rough 2011. We expect a successful re-starting of growth in places like China to lead to a rebound in 2012.

A combination of economic growth prospects and Middle Eastern political instability will continue to drive crude oil, which has been hovering over $100 per barrel recently.

Gold remains historically elevated. A pullback could follow a stabilizing of the EU situation. But overall, we feel a number of dynamics will continue to favor gold in 2012. These include the potential for printing of money in the U.S. and EU, low interest rates, high debt levels and currency uncertainty. In addition, gold remains a good diversifier in uncertain times like these.

The Bottom Line: A changing world, but one we can thrive in!

"Are we like late Rome, infatuated with past glories, ruled by a complacent, greedy elite, and hopelessly powerless to respond to changing conditions?"

-Camille Paglia

Our answer to the question above is a resounding no! For all the similarities of our situation to that of ancient Rome, there are also many differences. The ancient Romans were far more decadent and profligate than we are. While we will continue to complain about politics, don't expect the sack of Washington D.C. anytime soon!

But as we make our way through this period of deleveraging, witnessing the rise of nations such as China, as investors we must keep our eyes open to the tides of change. The days of stuffing a portfolio with domestic stocks and bonds and expecting predictable, strong and ongoing returns are gone. Greater diversification, being in the right mix of asset classes and the right parts of the globe are the new keys to long run success. We will position ourselves and our clients accordingly.

These remain volatile times, and we will continue watching the situation closely in order to respond quickly to any changes in outlook. As always, we send thanks to those of you that are our clients. We value the trust you have placed in our firm and we sincerely appreciate your business. If you have any questions or concerns, please do not hesitate to give us a call.