

2011 was a volatile and disappointing year for most investors. Expectations entering 2011 featured a continuation of economic recovery around the world from the Great Recession, despite ongoing deleveraging and residual debt and credit concerns. Debt and credit issues, however, obviously exploded over the past year, particularly in Europe. The investment landscape was one driven by fear and anxiety and while earnings were up in most places, multiples were down, causing equity markets to struggle.

We continue to operate in a post-credit bust world, a chief consequence of which is ongoing deleveraging. As a result, economic growth will likely be slow in 2012. Slow growth should be partially offset by the forces of accommodative monetary policy in much of the world, designed to provide the liquidity necessary for solvency and debt repayment. This combination of slow growth and debt repayment/deleveraging is likely to be a difficult one, fraught with occasional accidents and subject to low tolerance for policy errors.

A backdrop of slow, but positive, economic growth should allow for acceptable, but lackluster, earnings growth. Both “risk” and “safe” assets seem priced for such an environment, but not for a “left-tail” event whereby financial contagion could do significant damage. Our mainline scenario assumes a continued “muddle-through” global environment, especially regarding the European debt problem. Whenever deflation is a risk factor for the global economy, equity valuations remain under pressure. Importantly, the US household sector has been steadily restructuring its balance sheet and lowering its debt service ratio. This positive step, combined with some increase in the pace of job creation, provides hope for a better year for equities.

On the “what can go right” front, we would list Europe moving toward resolution of its debt crisis, the United States heading toward fiscal responsibility, the emergence of a US manufacturing renaissance, a housing recovery, and/or an increase in confidence. The “what can go wrong” list would include a systemic banking crisis in Europe, a true double dip recession in the United States, a hard landing in China, a breakout of class warfare in the United States, and a Middle East flare-up that drives the price of oil to \$150. Our “muddle through” base case avoids both extremes, but leaves much unresolved.

In summary, 2012 is likely to feature a slow-growth world that includes a recession in Europe. The United States faces headwinds, but manages to achieve growth of between 2% and 2.5%. China and India slow somewhat, but, along with the United States, make up two-thirds of global GDP growth. The big risk remains that of a financial breakdown in Europe, which would tip the developed world, if not the emerging world, into recession. Inflation should also continue to move lower. Should the muddle-through environment come to pass, we believe earnings and some improvement in confidence would allow equity markets to move higher, with US stocks leading the way.

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