The first week of 2012 was a positive one for risk assets as the flow of economic releases continued to be somewhat better than expected. Markets in the United States focused on the positive last week, and looked past rising oil prices and some data from Europe showing that a recession in that region was growing increasingly likely.

Recent positive economic data includes rising levels of construction spending, better manufacturing data and, perhaps most importantly, signs of improvement in the labor market. The December employment report was released last Friday, and showed that private payrolls grew by more than 200,000 jobs in the last month of 2011. The report also showed increases in average hourly earnings and the length of the workweek.

Importantly, the data also showed that unemployment fell to 8.5%. This is still, of course, a very high number by historical standards, and it would not be a surprise to see the number tick higher in the coming months as this indicator can be somewhat volatile, but it is important to note that the unemployment rate is now 1.5% lower than its peak in October 2009. It is beginning to look as if the economy is forming a positive feedback loop in which improving labor conditions are feeding into better conditions elsewhere in the economy, given that consumers are also benefitting from some stabilization in housing data and improved access to credit.

Over the last month, most economists have been quickly upgrading their forecasts for fourth quarter 2011 gross domestic product growth, and at this point it appears that growth for the quarter will come in somewhere over the 3% mark. Looking ahead, we also expect that we will see upward revisions for the first quarter of 2012.

As we have been saying for some time now, the world continues to operate in a post-credit-bust environment in which significant amounts of deleveraging still need to occur. The momentum in the United States is pointing in the right direction, but we do expect to see ongoing back-and-forth in the tone of economic data. Conditions will not continue to improve at the same pace we have seen over the last couple of months, nor will they deteriorate to the point that a double-dip recession becomes likely. Instead, we expect the economy to chart a middle course and grow somewhere between 2% and 2.5% for the year.

This sort of environment should be one in which risk assets (chiefly US stocks) should be able to post decent gains. The main risk, of course, continues to be the European debt crisis and while our base-case scenario is one in which uneven progress is made, the risks of a breakdown in the healing process are real and could derail our forecast.

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