

2012 Forecast: Reality Trumps Perception

As 2011 comes to a close, all eyes are on forecasting for 2012. The New Year holds perhaps more promise, but more importantly, a better way of looking at the potential of the future.

This year has been driven by two opposing forces. The reality of a slowly improving economy, and the perception of a deteriorating one. The perception has been driven by politics, the media, and in some circles an unwillingness to see how the economy is changing in structural ways. Added to this is the situation in Europe, where those who do not want to change or give up control of their country's finances speak in terms of apocalypse to those who do.

First, the reality. Housing foreclosures are down almost twenty percent from a year ago, as are personal bankruptcies. Consumer balance sheets are being repaired. The farming sector is enjoying record profits. The US economy is on track to record three percent GDP growth in the fourth quarter of this year. Auto sales are inching upwards. Interest rates are at record lows.

The perception advocates either ignore these issues or villainize them. Foreclosures are down because the courts cannot process them any faster. Consumer balance sheet repair will not take place until debt goes back to 1950s levels. Farmers are lucky. Government debt will drown us. GDP growth will falter next year, etc.

The issue of Government debt is the crux of the difference between perception and reality. After slumbering during the deficit years of the younger Bush administration, there is now a demand by the newly awakened that deficits be addressed, right now. If the economy, in its weakened state, cannot absorb the withdrawal of Government stimulus as evidenced by the deficits, then too bad.

As pointed out in previous *Perspectives*, Government surpluses should be the goal of the economy in full expansion. An economy in recovery or contraction cannot generate a surplus without aggravating the contraction. The problem is that this philosophy has not been practiced since the Clinton administration. Simply put, the public has no faith that the Government will carry out such an approach. The failure of

the Supercommittee to come up with a plan to close the deficit over a decade reinforces the notion of political inertia. The unwillingness of the President to stake a position and otherwise influence the debate was perhaps good tactics but bad strategy. No one can blame him for the failure, but no one will give him credit for trying to influence events.

Investment returns in 2012 will be influenced by efforts to maintain the current level of stimulus and in some cases expand it. If these efforts are not successful, there is an excellent chance that domestic demand will not be enough to keep the economy aloft. This will have repercussions for the financial markets on several fronts.

Another factor influencing 2012 will be the rise of export markets. Next year will mark the first time that demand for imports from the developing world will exceed that of the developed world. China is expected to become the world's largest importer by 2014.

The quadrennial presidential election will also be a factor in 2012. Hope springs eternal for a new beginning, the same hope that occupied voters' minds four years ago. Who gets elected will be a function of who gets nominated. Romney's administrative abilities appeal to independents more than to Republicans, who will choose their candidate. The possibility of a third party on the right being formed if the Republican candidate is not sufficiently conservative would probably dictate the election. On the Democratic side, early and often fund-raising by the President has insured that there was no financial oxygen for a challenger within his own party.

At some point voters will see the problem less as one of candidates or personalities or philosophies, and more as one of the system itself being broken and in need of repair. Unfortunately, we are not there yet.

Any other number of trends will impact 2012. The competition is intensifying between Saudi Arabia and Iran for influence in the Middle East, where the Arab spring is having far-reaching consequences. Europe will discover that it is easier to have a common fiscal structure than abandon a common currency. China will take steps to increase its influence over North Korea, to the advantage of everyone. Asian countries will get serious about infrastructure, which will be another job creator. Chinese wages will continue upwards, forcing the issue of the merits of keeping production offshore for American companies as opposed to bringing it back.

In sum, 2012 starts with great potential. All new years do. The realization of that potential depends on events. The market's reaction to events depends on its perception. After a year of pessimistic interpretation of events, perhaps the other side is to be given its turn. As reality marches on, even the pessimists at some point have to acknowledge that things are not so bad. Happy New Year.

The Economy

The economy continues to pick up the pace. While consumer spending is relatively neutral, job creation in other sectors such as health care, technical assistance, and the like thrives. The rate at which people are quitting their jobs voluntarily is increasing, indicating that people are beginning to feel more optimistic about finding a new job to the point of giving up the old one.

Interest Rates

Interest rates for US Government debt continue to hit record low levels. The rate for a ten-year Treasury bond is now 1.85 percent.

At some point, with Europe more stable, US interest rates will begin to rise. A goal for 2012 would be to see three percent ten-year bonds and four percent thirty-year obligations. While this would only be a gain of a bit more than one percent in both cases, it would represent a material shift in percentage terms and thus lead to significant losses in the bond markets. After three years of stellar returns, 2012 will be the year the high-grade bond market comes back to earth.

A more stable environment will conversely lead to significant positive returns on high-yield debt. Such debt trades in part on expectations that the economy is going into a recession. As such a perception is disproved, high-yield bonds should stage a rally.

Inflation

Inflation is still officially not an issue. Realistically, it exists, but not in a quantity that influences most people's thinking.

Inflation in 2012 will be influenced most by two things. On one hand, a falling dollar (due, in part, to its low interest rates relative to other parts of the world) will be somewhat inflationary. On the other hand, the Kingdom of Saudi Arabia has vowed to keep oil prices under \$100 per barrel. With so much labor slack, stable energy prices combined with moderate inflation from a falling dollar will spell another year of inflation in the range of 2-2.5 percent. Not deflation, but not runaway inflation either.

The Stock Market

Most stocks are priced for another recession in 2012. Unless the Government withdraws stimulus measures such as the payroll tax cut and unemployment benefits, a recession should not occur next year. Once this is realized, stocks should take off.

Economic activity in most of the developing world will exceed that of the US in 2012. This will create export opportunities for many companies.

Election years tend to be good for stocks. However, this year Government influence may be erratic as those who want to reduce the deficit clash with those who wish to expand the economy. Expect to hear a lot of talk about the inflationary nature of fiscal expansion, but do not expect to see it in 2012.

If energy prices are stable and the economy expands, expect the transportation sector to benefit. Auto sales are slowly growing, as replacement demand finally kicks in after years of contraction. Housing should do better in some regions such as the upper Midwest, where jobs associated with the energy industry create housing shortages.

Mitigating the upswing in the economy is the ongoing slowdown in population growth, the principal result of more aggressive enforcement of anti-immigration laws. The area most dramatically impacted is truck farming, as pickers for any number of fruits and vegetables cannot be found, resulting in crops rotting in the fields and the same produce being imported from countries that can find workers to harvest the output. It would seem that some guest worker program needs to be devised to address this issue.

Warren M. Barnett, CFA
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