Economic Commentary

January 23, 2012

2011 Review

Despite high volatility in 2011 the S&P 500 strangely finished at almost exactly where it began. However, during the year the Index was up 8.4% by April but down 13% by October. Of note, 38% of the days in 2011 experienced a market move greater than + or – 1% and 18% were over 2%. There were 69 days during the year when 90% of the stocks in the S&P 500 traded in the same direction, either up or down. That number exceeded the combined totals of 2008 and 2009, volatile years in their own right.

Markets therefore, were volatile but also were moving in unison. This suggests that macro factors, such as US and European political and credit factors had more influence on stock prices than economics and corporate earnings which is more the norm. Worth noting the S&P return including dividends was 2.1%, still not beating the rate of inflation. The Dow Jones 30 Stock Index was up 5.5% suggesting large capitalization and high quality names outperformed the average stock. This was further evidenced by the more broadly based NYSE Index which was down 6%.

Given all the negative news from Europe it is not a surprise that stock markets there were very weak: German DAX -15%; French CAC -17%; and the winner (and not in the Euro currency), England's FTSE -5½ %. However, the DAX has recovered and is up 24% since the low in October. More volatility!

Those investors who believed emerging economics were their salvation, were most disappointed as those markets fell markedly: China – 22%; Brazil -18%; and India -25%. Feeling the pressure from the above markets and economies, in particular the lower prices of commodities, the Toronto Stock Exchange was down 11% for the year.

US Fixed income was the asset class to have owned in 2011. Despite the S&P downgrade of the US credit rating in August, a portfolio of US Treasuries had a total return of almost 10%. If you had the prescience to own long-dated treasuries, the return could have approached 30% according to Barclays. Even the great Bill Gross of PIMCO missed those returns by selling treasuries early in the year, but then so did almost everyone else.

2011 In Review

We offer below some of the more important and interesting news and business stories of 2011.

January

- The Dow was up 2.7%, half of its full year return.

February

- Toronto market catches up with a 4.5% increase, based on higher commodity prices and the “risk on” trade.
- Protests begin in Arab nations. The Libya uprising, in particular, drives oil prices higher causing concerns about global economic growth.
- TSX and London Exchange propose merger. It is doomed to failure by mid-year.
- China becomes world’s second largest economy.

March

- Earthquake and tsunami in Japan rock world markets.
- Moody’s downgrades Greece and Spain, raising fears about Eurozone credit.

April

- China raises rates to cool the economy and inflation.
- US Congress cuts last minute deal on budget to prevent government shutdown.

May

- Bin Laden killed.
- IMF leader is arrested, leaving fund rudderless at key time.
- Harper wins election. NDP takes Quebec and Liberals are wiped out.

June

- Greek situation worsens. Interest rates spike higher and riots break out.
- Sino Forest is accused of fraud. Stock will be shut down in August.

July

- New solution in Europe proposed sending markets higher. Really doesn’t solve the problem.

August

- Again US Congress waits for the last minute to pass debt ceiling deal. It’s not enough for S&P, which downgrades US credit rating. Treasury prices, nevertheless, rally.

September

- Admitting the July solution isn't working, leading world central banks agree to provide as much US dollar liquidity as the financial system needs.
- *Occupy Wall Street* protests begin

October

- Federal Reserve begins "Operation Twist" to bring down longer term US interest rates.
- More "emergency" meetings in Europe leading to proposed increase in "stability fund".
- US broker-dealer, MF Global, declares bankruptcy. Billions of dollars missing.

November

- Greek Prime Minister proposes referendum on bailout. The idea fails and he resigns. Italy's Berlusconi, under pressure, follows suit and also resigns.
- US Super Committee of Congress admits defeat. Answers to deficit reduction and budget are pushed out into the future.

December

- US retail sales provide positive news but the increase in consumer debt levels and decrease in savings rate mute those results.
- US unemployment numbers appear to be improving. The caveats are that a quarter of the new jobs were for couriers and messengers for the holiday season and more people are dropping out of the job market.
- In the spirit of the festive season, the new head of the IMF, Christine Lagarde, opined that the world is at serious risk of sliding into a 1930's style slump.

2012

Without offering an opinion on the final outcome, here is what we see as the issues that will move markets in 2012.

The most important factor is, can Europe sort out the problems in the weaker members of the EEC. There is no easy solution when you have a system with one monetary policy buy very diverse fiscal policies. Attempts to force common and prudent fiscal policies in countries that have been profligate for years are sure to meet with resistance. Witness the riots in Greece and Italy. In addition the European Central Bank cannot by law, provide new liquidity directly to the troubled countries. However, if through a bailout fund or other method, a way can be found to buy time for those economies to get back on courses it will be very positive for all markets. Watch for very large sovereign bond issues in March as a signal of success or failure.

Elections will bear watching as new leadership could well change how the year will unfold. Egypt is the first of the new Arab democracies to elect a new government. It could be telling for the balance of power in the Middle East. Russia will vote for a President and Putin is not a sure thing as in the past. France will go to the polls in April with a good chance of a new President there. Without Sarkozy, how will the French approach toward the Eurozone change? German elections will take place in 2013, but Merkel will be aware, as she positions herself in European negotiations.

This brings us to the November elections in the US. Both parties have taken very strong positions on deficit reductions, the budget, taxes, etc. It will be very difficult to compromise as they have staked their ground for the elections. Unfortunately, all of these issues are very crucial to the economy, business decisions and financial markets. Uncertainty is a negative. Hopefully we will see some positive outcome.

The US economy has shown recent signs of improvement. While not robust, if the positive reports continue, that will be good for all stocks. Europe seems to be headed for a recession and worse if no solution is found politically. Emerging nations have not been as strong economically of late. In particular, China has taken steps to rein in rate of growth. These steps have been effective and with inflation seeming to be under control, perhaps more simulative measure are in the offing. Globalization has made the interconnections between world economies more significant. Any positives or negatives in one region will have a marked effect on the others. This is particularly important to Canada.

The world governments are between the proverbial rock and a hard place. Austerity is needed to bring deficits and budgets into line, but puts a strain on the economic growth we so desperately need. On the other hand, attempts to promote growth mean we ignore the need to come to grips with our debt problems.