



## The “Muddle-Through” Economy

January 25, 2012

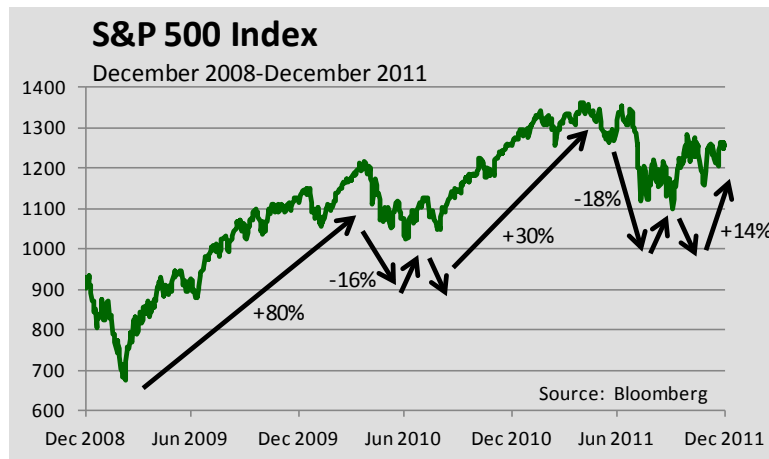
### Summary

In 2011, the U.S. economy was able to avoid a double-dip recession, but the year was anything but “dull.” After the Japanese disaster, European debt crisis, worries over a pending recession and numerous political tensions, the S&P 500 index closed the year at 1257.60, virtually unchanged from 1257.64 a year earlier. Despite mildly positive stock returns in the major U.S. indices, almost all other equity investments had negative returns in 2011. Small company U.S. stocks, most developed nations outside of the U.S. as well as many emerging nations suffered losses for the year. Prices on U.S. Treasury bonds went higher and higher despite downgrades of the U.S. Treasury credit rating and little movement on resolving U.S. budget deficits.

Many investors are expecting the economy to continue “muddling-through” and hoping for a calmer year. Although a “calm” year is unlikely, in some ways such low expectations can create an opportunity to be pleasantly surprised. The list of potential bear market triggers is long, and any meaningful progress toward eliminating or reducing the long list of market impediments could boost equity market returns past the consensus single digit expectations.

It does seem likely, however, that the positive momentum initiated in October continues until midyear. The current market rally could be characterized as a shorter-term, cyclical bull market inside of a continued longer-term, secular bear market. Those cyclical bull markets inside of secular bears tend to be shorter in duration and exhibit high volatility. Slowing momentum in the spring could allow any number of potential unknowns to unwind a large portion of the rally that began in October.

The biggest risk for 2012 remains the political crisis in Europe. The Financial Times recently reported that Nicolas Sarkozy, president of France, said the gravest crisis Europe has faced since the second world war “is not over,” and Angela Merkel, German chancellor, told German voters “next year will no doubt be more difficult than 2011.” If the euro-zone can avoid significant turmoil, the U.S. could have a reasonable year of growth and market returns.



Typically at this time of year, we would follow the strong seasonal and presidential historical tendencies with high equity allocations. In recent months, however, the risks to markets posed by euro-zone instability and election year politics have forced us to remain somewhat defensive, in a “neutral” equity position. The environment in Europe is dynamic, and until the market crisis risk has lessened, we expect to remain somewhat conservative in portfolios.



## 2011 Year in Review

2011 was one of the most challenging investment years in a long time. In some respects, it is surprising that the S&P 500 was able to close flat for the year. The first half of the year was reasonably positive. But by mid-year, market volatility increased substantially as a series of headlines caused angst for investors worldwide.

For the year, large company stocks (i.e. the S&P 500) finished within a hair of where they started, despite a lengthy list of obstacles encountered throughout the year. There is risk each year that external events will have a significant impact on financial markets, but the list of market dramas in 2011 is lengthy.

**Japan Disaster:** In March, the world's attention was focused on Japan as a result of the tsunami and subsequent nuclear disaster. In addition to the physical devastation, many commentators worried about the global impact of the event on the world's third largest economy and its role in the global supply chain.

**Budget Battles:** Over the summer months, the debt ceiling became the central battleground for conflict between Democrats and Republicans. In May, the Treasury Department said that the debt limit of \$14 trillion had been reached, but could keep the government functioning normally by "extraordinary measures" that would run their course by August 2<sup>nd</sup>. Numerous ideas for a solution were provided and rejected. On July 31, both parties announced an agreement to raise the debt ceiling. A bipartisan Congressional commission, or "super committee," was created to identify further deficit reductions. And failure by the super committee and Congress to enact those cuts would lead to across-the-board cuts in military spending, education, transportation and Medicare payments to health care providers. No progress has been made since the committee reached a stalemate in November. If a solution is not found, the mandatory cuts will be enacted in January 2013.

**U.S. Credit Rating Downgrade:** In early August, after the debt ceiling solution, Standard & Poor's Rating Services lowered its long-term sovereign credit rating on the United States to 'AA+' from 'AAA' and indicated that the outlook on the long-term rating was negative. Interestingly (or ironically), U.S. Treasury bond prices have significantly increased in value since that announcement. Downgrades are typically accompanied by an increase in the interest rate a company (or country) must pay, but the U.S. is currently viewed as "the best house on a bad block."

**Arab Spring:** Throughout the year, the Middle East and North Africa encountered significant turmoil. A flourish of demonstrations and protests resulted in changes of government in Egypt and Tunisia, war in Libya, as well as major disruptions in over 10 other nations.

**European Debt Crisis:** Over the summer, bond markets lost faith in the ability of several euro-zone members' ability to repay their debts. In May, June and July, several agreements were reached but failed to generate the necessary confidence. Borrowing costs increased significantly for Italy, Spain, Portugal, Ireland and Greece. In October, after at least 13 European summits since the first Greek debt crisis in 2010, European leaders finally crafted a plan that garnered credibility with financial markets. Since the plan is light on details, the negotiations are not yet complete.

If you had expected this list of headlines, most investors would have also expected significant losses in global equity markets. In the face of such headwinds, the resilience of the U.S. economy is a positive sign moving into 2012.



## Last Year's Expectations

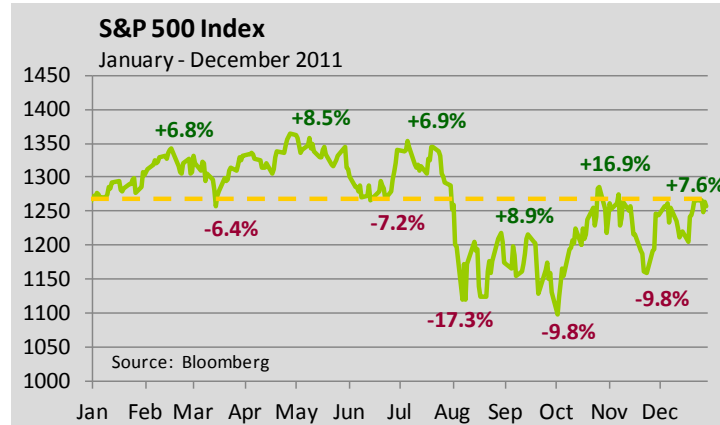
As 2011 began, we were skeptical that the strong recovery from the 2009 bottom would continue. And, unfortunately, our expectations for 2011 were not too far off. Excerpts from our January 2011 Outlook are below:

*"Although no crystal ball exists, we feel positive about the upcoming 3-6 months. However, it is uncertain how the economy will evolve, and as time passes, it is increasingly likely that a stock market correction will occur. In our view, the middle part of the year remains a period of elevated risk and is the one most likely to realize a correction. Whether that correction is minor or qualifies as a "bear market" (a 20% pullback) is unclear...."*

*"After a minor pullback in the first quarter, we expect the market to continue with strength through mid year. Depending on the breadth and momentum of the market during the first half of the year, it would not be surprising to see significant weakness again during the summer months... Several indicators reveal that the market may be overdue for a correction; that risk will likely increase throughout the year, and that makes us more cautious than most strategists."*

In retrospect, our stock market expectations for the year were mostly valid. The first four months of the year were positive, including a shallow pullback in March of 6.4%. The market peaked on April 29 at 1363 on the S&P 500. The summer months were relatively weak, as the market fell by 18% in July and August. The combination of seasonal and presidential election tendencies would typically produce a strong fall rally, and financial markets did realize some recovery in the fall but have not yet revisited the high reached in April.

Although we were able to avoid some of the mid-year stock market losses through our May 18 equity reduction, international markets (both developed and emerging) did not recover in the fall as U.S. markets did.



Our expectations for bond returns were less accurate, as our concern over the inevitable rise in U.S. interest rates did not materialize. The combination of the European debt crisis and monetary policy actions pursued by the Federal Reserve has continued to put downward pressure on both short- and long-term interest rates. As long as there is fear of a major financial crisis in Europe, investors will continue to seek the safety of U.S. Treasury bonds, and it will be difficult for rates to rise significantly until that crisis is closer to resolution. By avoiding significant interest rate risk through allocations to shorter-term bonds, the bond portion of portfolios missed modest gains of the Barclays Aggregate Bond Index. The Index has a duration of roughly 5 years, which means a 1% rise in interest rates will drive down the price by 5%. We are at the tail end of a 30 year bull market in bonds. Since reaching an historical high interest rate of 15.84% in September of 1981, the 10-year Treasury bond fell to a record low of 1.83% in September. Given the risk posed by interest rates to bond returns, we are still content to avoid risk in the relatively stable portion of portfolios. Although interest rates may not rise dramatically this year, it will be difficult for bonds to post strong returns in 2012, barring some financial crisis.

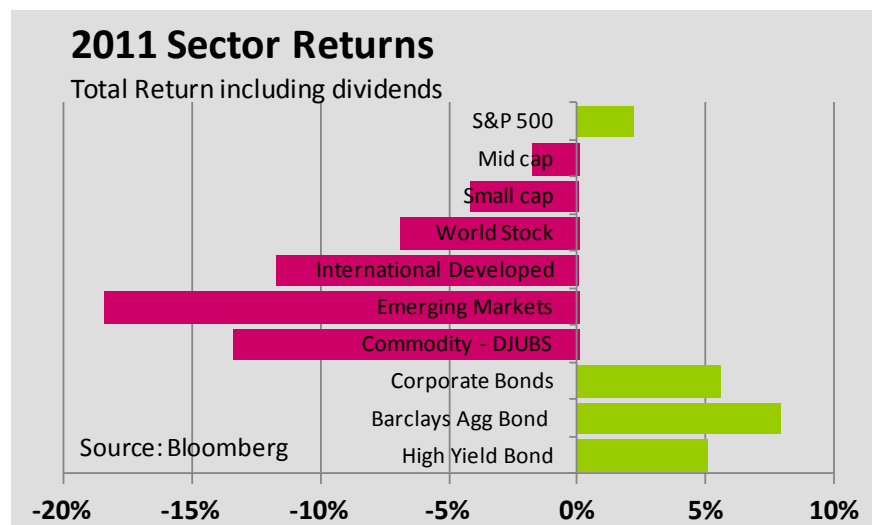


## 2011 Financial Market Results

Stock market returns were mixed for 2011; large cap U.S. stocks were the strongest performing equity market and ended barely positive. While large U.S. company stocks (represented by the S&P 500) were flat, most other equity investments were negative for the year. Economic growth was slower than expected for most of the year, and worries about a pending recession impacted small company stocks, which lost 4%. Growth stocks slightly outpaced value stocks, returning 2.6 % versus 0.4%.

Little headway was made in the European crisis, almost assuring a recession in 2012 and resulting in losses of 12% in developed international stocks. A combination of inflationary fears and concerns over the impact of a world economic slowdown caused emerging market stocks to lose 18%. The U.S. dollar appreciated versus most currencies which added to downward pressure on foreign returns.

Concerns over slowing economies in emerging markets (China in particular) created a mixed year for commodities. The most diversified commodity index lost 13%, while more energy focused indices were down only 1%.



The “flight to quality” (investors moving capital away from risk assets into the safest possible investment vehicles) due to the lengthy list of world crises put upward pressure on U.S. Treasury bond prices, resulting in the lowest interest rates in history. Consequently, higher quality, investment grade bond investments gained 8% on average. Lower quality, high yield bonds gained 5%, while short-term bonds earned 2%. During the year, the yield on a ten-year Treasury bond, for example, fell from 3.3% in January to 1.9% at the end of 2011. During the same period, 20-year Treasury bond yields fell from 4.2% to 2.6%, and 30 year bond yields fell from 4.4% to 2.9%. These changes exemplify recent headlines such as, “the fed punishes savers.” As Treasury bond yields fall, it becomes harder for savers to find conservative investments that will generate a reasonable return. It will be difficult for investment grade bonds to repeat such strong returns in 2012.

2011 was a year in which higher risk investments realized lower investment returns (or greater losses). We do expect riskier asset classes such as emerging market equities to be solid contributors to portfolio performance over time. However, diversification out of U.S. equity markets was a drag on overall performance in 2011.



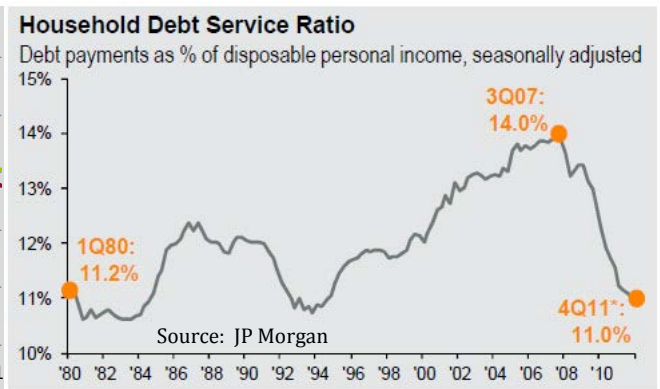
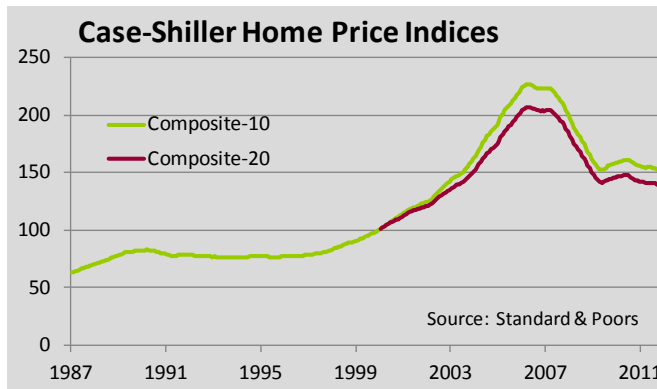
## A Lot of Wood to Chop – Looking Forward at the Economic Environment

Looking forward into 2012, perhaps one of the best ways to characterize the economic outlook is as having “a lot of wood to chop.” The image should conjure a task that is significant in size and scope, requiring strength and endurance; a lot of heavy lifting must occur on numerous fronts, but the desired outcomes are achievable. The list of required heavy lifting is not short, and the top items on the list are large potential problems, that, once solved, could become positive forces for both the world economy and financial markets. The current list of wood to chop includes:

- 1) Positive movement in the real estate market in the U.S.
- 2) The impact of de-leveraging on real estate and consumers
- 3) Job creation and lower unemployment in the U.S.
- 4) Clarity on federal income tax structure and budget deficits
- 5) Maintaining positive earnings growth as European and Chinese economies slow
- 6) Progress towards greater fiscal unity in the European Union

### Residential real estate

Home prices in the U.S. continue to stagnate. Despite record low mortgage rates, the price of homes has continued to slip over the past 18 months. The Case-Shiller home price index is a “constant quality” index of home prices in the U.S. calculated as a composite average of 10 and 20 cities. This graph (see below) shows the nominal, seasonally-adjusted price for the two indices; the Composite 10 index is off 32.9% from the peak at a new post bubble low; the Composite 20 index is off 33.0% from the peak and also at a new post-bubble low. It will be difficult for the economy and markets to deliver positive results unless real estate prices stop declining.



### De-leveraging

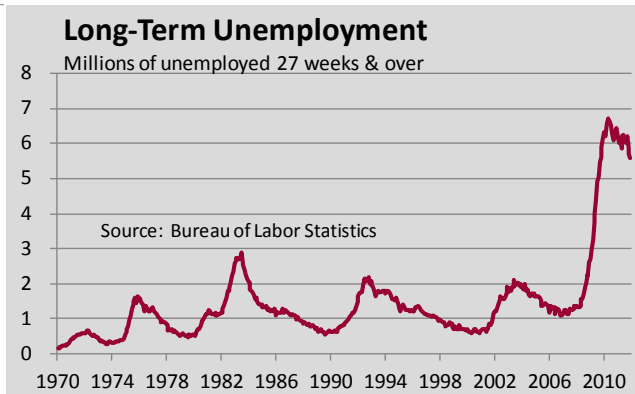
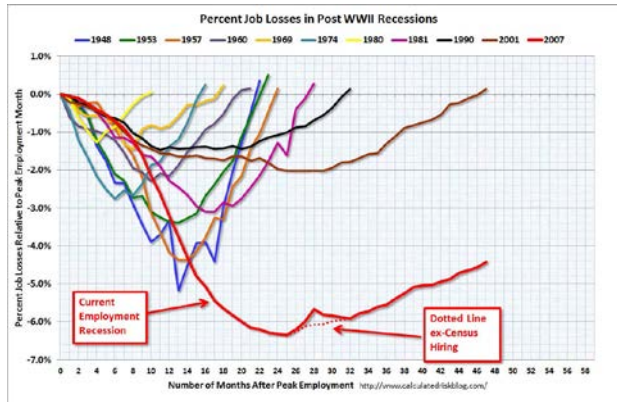
Although many consumers have continued to de-lever, their healthier balance sheets (household debt service ratios, see above, are at the lowest level since the early 1990's) have not translated into higher property values. The “wealth effect” of rising home values has a significant impact on consumer spending, and thus property values will be an important indicator for increased confidence in financial markets. Reduction in credit card and other debt also points to healthier economic conditions.

### Jobs in the U.S.

In 2011, the economy added approximately 1.7 million total non-farm jobs or just 140 thousand per month; the pace of job creation was stronger than 2010, but the economy still has 6 million fewer payroll jobs than at the beginning of the 2007 recession. The unemployment rate has fallen slightly to 8.5 percent; however, many workers have stopped seeking employment, which makes that improvement slightly misleading.



This job recovery is the slowest recovery of all recessions since WWII (see chart, below). One important measure of a strengthening U.S. economy will be significant improvement in job creation.



### U.S. Political

In the aftermath of the debt ceiling debate and failure of the “super committee,” political uncertainty will be high over the next 6-12 months. In terms of government actions, there are numerous items that could infuse some confidence to markets in the short run. But given the polarized environment, it is becoming increasingly difficult to expect any good news from Washington that could help the stock market. On the horizon are the expiration of various stimulus efforts, including the payroll tax cuts, enhanced unemployment benefits, and bonus depreciation for capital spending. The Bush tax cuts sunset at the end of 2012, but little progress is expected on that front until after the November election. The uncertainty created by an extremely contentious election may also weigh on the market. The uncertainty will fade as the election nears; it is not uncommon for a rally to begin a month or two before election day.

### Slowing corporate earnings

Corporate earnings growth is expected to slow in 2012; the key question is by how much they will slow. Aggregate corporate earnings for the S&P 500 as a whole are expected to break a run of eight consecutive quarters of double-digit gains. Consensus expectations for earnings growth in the fourth quarter of 2011 are only 7%; expectations are only 3% for first quarter of 2012.

### Euro-zone instability

The European debt situation is complex, encompassing difficult to navigate issues on both political and financial fronts, but it is likely that the resolution comes from one of two general outcomes. If the euro zone countries agree to some sort of binding fiscal measures and tighter economic unity, the potential crisis should be averted. As French President Nicolas Sarkozy stated, “There cannot be a single currency without economic convergence... or the euro zone will collapse.” If the euro zone cannot agree to stronger economic integration, it is unlikely that the membership of the European Union would remain the same, and financial tensions would increase dramatically. This issue is important for financial markets, not only because European banks are significant global lenders (particularly to emerging markets), but also because of confidence in global markets. This lack of confidence caused credit markets to tighten significantly (banks afraid to lend to one another), reviving memories of the 2008 financial crisis.

Despite well-intended European Union members, it will be difficult to produce a conclusive outcome in 2012. The most likely path is for European leaders to do the minimum to avoid a catastrophe while buying time for banks to strengthen their financial positions. Obviously, any significant steps backward could cause significant turmoil.

### External event

There is always risk of a negative impact from numerous unknown events such as Iran closing the Strait of Hormuz, increased tensions between Iran and Israel, or other fallout from the “Arab Spring.”



## Presidential Election Cycle

The presidential election cycle is an interesting historical trend that can provide meaningful context to the investment environment. A common misconception is that the stock market is likely to be positive in election years. Although some interesting trends do exist, on average, presidential election years are just average. In fact, since 1920, 67% of election years were positive (compared to 68% of all years). The impact of presidential politics is most clearly felt in the pre-presidential election year (e.g. 2011) when there have been no stock market losses since 1950.

Year	President	Party	Dow returns
1920	Wilson	Dem	-32.9%
1924	Coolidge	Rep	+26.2%
1928	Coolidge	Rep	+48.2%
1932	Hoover	Rep	-23.1%
1936	Roosevelt	Dem	+26.1%
1940	Roosevelt	Dem	-12.7%
1944	Roosevelt	Dem	+12.1%
1948	Truman	Dem	-2.1%
1952	Truman	Dem	+8.4%
1956	Eisenhower	Rep	+2.3%
1960	Eisenhower	Rep	-9.3%
1964	Johnson	Dem	+14.6%

Year	President	Party	Dow returns
1968	Johnson	Dem	+4.3%
1972	Nixon	Rep	+14.6%
1976	Ford	Rep	+17.9%
1980	Carter	Dem	+14.9%
1984	Reagan	Rep	-3.7%
1988	Reagan	Rep	+11.9%
1992	Bush Sr.	Rep	+4.2%
1996	Clinton	Dem	+26.0%
2000	Clinton	Dem	-6.2%
2004	Bush Jr.	Rep	+3.2%
2008	Bush Jr.	Rep	-33.8%
2012	Obama	Dem	???

Legend
Gain over +10%
-5 to +10%
Loss over -5%

Source: Bloomberg, Street Smart

Interestingly, the cause and effect seem to be reversed in election years when stock market returns seem to impact election results. It seems intuitive that when the economy (and thus the stock market) does well that it would be easier for the incumbent party to win re-election. And when the economy is doing poorly, the incumbent party is often blamed for not generating positive results. In this case, the intuition and data seem to match; there is a strong correlation between the two. Of the 6 election years where the stock market returned a loss of 5% or worse, 5 of 6 incumbent parties lost the election (the sole exception was during WWII). And of the 10 elections where the stock market returned a gain of over 10%, the incumbent party was re-elected 80% of the time (the two exceptions were 1976, which was post-Watergate, and 1980, a year in which inflation was 14% and thus the real, inflation-adjusted return was essentially zero).

When the market returns	# of years	% incumbent party wins	% party incumbent loses
Gains over +10%	10	80%	20%
Between -5% and +10%	7	57%	43%
Losses over -5%	6	17%	83%

Source: Bloomberg, Street Smart

While it is too early to forecast the November election, economic uncertainty has an important impact on both presidential politics and the stock market. NDR summarized the outlook for next year succinctly, "Whether 2012 turns out to be a good year for the market, and whether Obama returns to the White House in 2013, will have a lot to do with whether the economy can continue to avert recession."



## Financial Markets Outlook

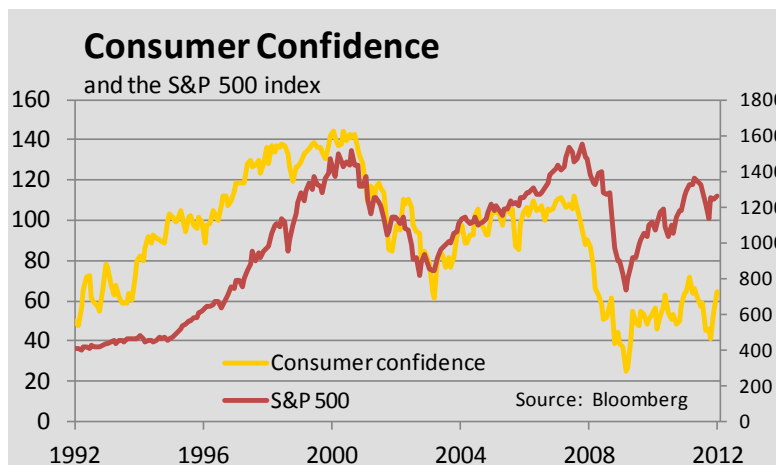
The high level of market volatility experienced over the past few years is likely to continue. The stock market could be poised for a strong year, but there are many obstacles to navigate along the way. Many investors expect a “muddle through” economy where economic growth, job creation and residential real estate values are positive but quite slow. With expectations set so low for the year, a few positive surprises could generate an environment for solid market returns. But, significant risks remain that could derail the recent recovery.

In the short term, it seems likely that financial markets will continue the uptrend started in the late fall, driven primarily by:

**Improvements in general economic conditions:** Economic growth in the U.S. stalled in the first half of 2011 causing fears of a double-dip recession. Growth in the second half of 2011 was stronger, with third quarter U.S. Real GDP growth increasing at a 1.8% annualized rate. Other countries outside of Europe are experiencing modest growth; China, while slowing, seems likely to avoid a “hard landing,” with year-over-year GDP growth of 8.9% in the fourth quarter. Concerns over a potential real estate bubble in China could threaten that strong growth over the next year or two. Corporate earnings for U.S. companies in the fourth quarter continue to beat analyst estimates but at a diminished rate; Thomson Reuters reported that so far this quarter, just 59 percent of companies beat earnings estimates, well below the 70 percent plus in recent quarters.

**Liquidity Measures:** Central banks around the world continue to provide significant liquidity to financial markets, most recently through a reduction in rates charged for overnight dollar loans between banks. A coordinated effort by the European Central Bank, the Federal Reserve and the central banks of Canada, Switzerland, Japan and the U.K. reduced the premium banks pay to borrow dollars overnight from central banks by half a percentage point to 50 basis points. This action, which will continue through at least early 2013, will reduce tensions in financial markets. Additionally, the Federal Reserve continues to communicate expectations of easy monetary policy for several years.

**Consumer confidence:** Consumer psychology can be an important indicator for human behavior and investing; typically, consumer confidence is a contrary indicator, meaning that low levels of optimism are a positive signal and high levels of optimism are cause for concern. Highs in consumer confidence coincided with stock market peaks in 2000 and 2007; lows in consumer confidence coincided with stock market bottoms in 2003 and 2009. Although low consumer confidence feels discouraging, continued improvement on that front can be a sign that economic conditions are improving. The consumer confidence index was established in 1967, and the average 6 month stock market return during that period is 4.0%. When consumer confidence is between 60 and 80 and rising (as it is today), the average 6 month stock market return is 9.4%, more than double the long-run average. Even if earnings continue to slow, increased consumer confidence could fuel positive stock market returns through P/E multiple expansion.





In the intermediate term, there is risk that a known or new issue flares up and causes a sharp pullback in financial markets. It seems likely that the governments in Europe will continue to do the minimum to stave off a financial crisis but will not reach a conclusion to their debt issues and fiscal unity.

Equity markets are likely to remain volatile, particularly in the summer months. If the market can continue in a positive direction through the spring, it is unlikely that the market will be able to avoid some sort of correction in the summer months. Once the European debt refinancing (and political) crisis is resolved, the world may be able to return to a more normal environment where markets are driven by economics and growth prospects instead of fear. Until that happens, we are not confident that the U.S. markets can separate themselves from potential liquidity problems in Europe. Although we have reduced equity allocations to developed European nations, any substantive problems will have a broad impact, dragging down most equities including those in the U.S.

Equity investors continue to be quite nervous despite strong stock market gains in two of the last three years. Market volatility has been difficult for many to stomach, and as a result, since 2007, over \$450 billion of investment has been withdrawn from U.S. equity funds. We obviously share some of those concerns; however, we do expect equities to outperform bonds over the next 5 years, and that a large portion of those monies will return to the stock market when investor confidence returns.

The current environment is dynamic. Strong economic results one week, followed by a potential European implosion the next. In the fall of 2011, six central banks announced an unprecedented, unified policy action to increase the liquidity of financial markets. Although the true need of such action may not be known for years, it is clear that some European financial institutions were close to a Lehman-like liquidity event. We were unwilling to take on more equity risk given such potential problems and are unlikely to increase equity exposure until the situation is more stable.

This will be a difficult year to navigate, with uncertainty created by two important opposing forces: the recovering economy and instability in the euro-zone. As a result, we are likely to remain cautious with our equity allocations until concerns over debts and politics in Europe subside. If you would like to be more aggressive in your portfolio, please call us to discuss your situation.

If you have questions on the investment environment or your portfolio, please call us at 734-769-7727. To find an electronic copy of this document and other recent commentaries, please visit our **NEW WEBSITE** at [www.risadvisory.com](http://www.risadvisory.com).

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Past performance is not indicative of future results. This is for illustrative purposes only and is not indicative of any investment or strategy result. The S&P 500 is an index of 500 stocks representing major U.S. industry sectors. The Dow Jones Industrial Average is an index of 30 large U.S. company stocks. Small Cap is represented by Russell 2000 Index, which is an index of the 2000 smallest companies in the Russell 3000 Index of 3000 broad-based U.S. companies. Mid Cap is represented by S&P MidCap 400 Index, which tracks medium-sized U.S. firms, which is broadly defined as a company with a market capitalization ranging from about \$2 billion to \$10 billion. Bonds are represented by the Barclays Aggregate Bond Index includes most U.S. traded investment grade bonds, including Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S. Large Growth is represented by the Russell 1000 Growth Index, which measures the performance of the large-cap growth segment of the U.S. equity universe; it includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth rates. Large Value is represented by the Russell 1000 Value Index, which measures the performance of the large-cap value segment of the U.S. equity universe; it includes those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth rates. Developed Int'l is represented by MSCI EAFE Index, which is an index of major international equity markets as represented by 21 major MSCI indexes from Europe, Australia and Southeast Asia. Emerging Markets is represented by MSCI Emerging Markets Index, which is an index that is designed to measure equity market performance in global emerging markets (over 20 countries including Brazil, Russia, India, and China). World stock is represented by the MSCI ACWI Index, which is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. Commodities are represented by the Dow Jones-UBS Commodity Index, which is a broadly diversified index that is composed of futures contracts on physical commodities. Indices are unmanaged, and one cannot invest directly in any index.