CONWAY• JARVIS LLC
Investment Outlook

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What a Difference a Day Makes

New Year's Day that is. The arrival of 2012 was a "switch on" moment for the world's stock markets as January delivered a great start to the year. Not only did the "Fear Trade" complete its retreat to the back-burner that began in late December, there was a "role reversal" among last year's best and worst performers. Market sectors that led returns in 2011 were relegated to obscurity while January was "worst to first" month for the Emerging Markets Index ("EEM"). After spending 2011 in the doghouse, those stocks assumed the top spot with double-digit returns at month's end. So, what has changed? Volatility, or rather the lack of it.

The January 30 issue of Barron's enlightened readers to the fact that last year there were 68 sessions of "risk-on/risk-off" trading that pushed the S & P 500 up or down more than 2% as compared to just two in all of 2005. Also in 2011, there were 70 sessions where the advance/decline ratio of the S & P 500 was in excess of 4:1. There were only 67 such days in the raucous period of 1990-2004. Such volatility, while embraced by those of the trading persuasion, makes it very tough for *investors* to "stick to their guns". And by guns we mean diversified portfolios constructed on the basis of fundamentals and with an investment horizon of more than a week. So, why are 2012's markets so seemingly stable and sanguine once again? Maybe it was the holidays that served as a distraction to fatigued traders as volume dried up the week ahead of Christmas? Or perhaps the lack of success derived by hedge funds from such record volatility? More likely, it's acceptance of the reality that Europe's debt crisis is solvable and won't be a fatal blow to the global financial system.

Europe is Center Stage

The volatility we witnessed in the second half of the year was an indication that investors were fearful that policy-makers in Europe would freeze like their US counterparts at a moment when action is required to restore confidence. Through all the discussions, delays, and creations of rescue funds with catchy acronyms in 2011, there emerged a vision of the world's central banks being committed to overcoming their intransigence to stem any contagion that might emerge from a Euro-Zone ("EZ") member's sovereign instability. We believe that message was received loud and clear by the investment community during the holiday hiatus and accounts for much of the market's advance in January.

We see an increasing likelihood that Greece won't make the final cut and remain a part of the Euro-Zone team in the future. They might make it through the first iteration of ECB-directed bailouts this Spring but we bet they eventually succumb to the cultural and economic barriers to competitiveness and organic growth needed to become self-sustaining. We see a default sometime in the future that would leave them as part of the Euro-Union (not Zone) and printing Drachmas to trade along with Euros. We take the current lack of volatility as an indication that the default may already be priced into the market. All eyes are focused on what comes after that. Portugal, Spain, Ireland, and Italy are at risk but that is part of the conversation taking place at the highest levels of global central banking. The ECB is almost certain to draw their wagons around these other troubled sovereigns since they appear to be salvageable. That gives us some confidence that the market's advance can continue well into 2012 after some brief consolidation.

Clouds on the Horizon

There are always doubters and the currently low trading volume gives rise to concerns for some in 2012. Joe Granville, a market seer who rose to fame in the 70's emerged several weeks ago to announce that his OBV (On Balance Volume) model, circa 1961, predicted that the market had topped on January 20th and will give up 1000 DOW points per quarter this year. Someone might want to break it to Joe that a few things have changed since 1961 when daily NYSE volume was 4 million shares and the US was essentially the Global Economy. Today, volume is measured in the billions and the Global Economy is so much more than just the US. Lest anyone doubt that, we would point to the fact that US fiscal-policy makers have failed to deliver a budget since 2010 and remain paralyzed in an election year while the global economy and the markets have mounted a healthy, though fragile recovery. Absent a significant geo-political event, we think Joe will be left standing at the station as this recovery heads down the tracks much like he was in 1982 when stocks were launched into a 5-year bull market.

Aside from the usual predictions of doom that surface daily on TV, there are risks to this generally positive outlook that should be considered. Fed Chairman Bernanke was careful to point out in his recent remarks before Congress that this recovery is vulnerable to financial shocks and event-risk. Most prominent of these risks is the prospect that Iran overreaches in its zeal to become a nuclear power and provokes Israel into a response that spreads unrest throughout the Mid-East. A second order effect could likely be constraints on oil supply, sending prices skyward and delivering a shock to the global economy.

We think Europe will stumble its way to a resolution of its debt crisis. That leaves only the void in US fiscal policy looming on the horizon. As we've said before, Congress and the administration have essentially removed themselves from any serious role in the advance of the global recovery. In fact, we think their inaction has actually done more good than harm in the aftermath of the debt-ceiling comedy that played out last summer. Somehow, the private sector has managed to plod along robustly without an assist from government. Makes you wonder. However, that will take us only so far and the private sector will demand certainty in the fiscal and tax policy arenas in 2013. Otherwise, the erosion of confidence in the business sector could stall or even derail the recovery in the US.

We see 2012 as a year where uncertainty subsides in Europe but increases in the US around the results of the November elections. Call us moderately bullish as of today. We expect stocks to post returns in the mid-to-high single digit range with dividend income being a significant contributor to that result. Next month we'll revisit the subject of the dividend-dependent, total return strategy that we introduced to risk-averse investors in 2009.