CONWAY • JARVIS LLC
Investment Outlook

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First Quarter 2012

As noted in our January Outlook, the global stock markets entered the New Year with upside momentum gathered from the bull-run that began in October. The uptrend continued through the 1st quarter of 2012 leaving the MSCI All-World, S&P 500, and the Emerging Markets ("EEM") with gains of 11.3%, 12.2%, and 13.65% respectively. The outliers were EAFE, up 9.97% in anticipation of what will almost surely be recession in Europe, and the NASDAQ which posted an outsized gain of 18.8% courtesy of Apple's hefty weighting within that index.

However, we saw some divergences among the benchmarks in March that leave us thinking the stock market might be ripe for some consolidation. For the month, the S&P 500 gained 3% while EFA gave up 0.9% and EEM lost 3.5%. The MSCI All-World benchmark's return of +0.4% for March reflected the bifurcation of returns between foreign and domestic markets. That dispersion of returns hints of a flight to safety by investors. We believe the markets are anticipating that Europe's recession will marginally impact China, the EEM, and global growth, while leaving the US once again as the "least dirty shirt" among the world's economies. However, we don't expect a return of the Fear-On/Risk-Off trade that roiled the markets last year but rather a more muted reaction to Europe's problems and uncertainty surrounding the US elections.

Revisiting Our Outlook for 2012

Asked by a client the other day where we saw the market going this year, we replied that our modest expectations for 2012 had been already surpassed in the best first quarter since 1998. This rally followed what many skittish investors thought was a sure return of recession and a return to the days of Q4 2008-Q1 2009. That didn't happen. So, what's changed over the past six months? Not as much as the stock market's action might imply but enough to provide a respite from the day-to-day news of crisis management in Europe. They are still a long way from putting their credit/deficit problem to bed once and for all but the crisis is increasingly being viewed as more regional than global. That and evidence of a persistent though fragile recovery could push stock prices higher from here by year-end.

Denial is no longer an option for Europe. The can is too big and too heavy to kick any further down the road. It's been forced to acknowledge the reality of being a dysfunctional group of socialist democracies, meritocracies, and everything in between. Germany and the ECB have assumed the role of stern parent to Greece. Seeing this, Spain, Portugal, and Italy have enacted austerity measures in an attempt to avoid the same fate as Greece: a decades-long period of being "grounded" under the watchful eye of a central fiscal authority. While those countries may succeed, we fully expect Greek society to chafe for only so long under the relentless oversight of the central bank and IMF before bolting from the Euro-Zone. The reality is that Greece, by virtue of its miniscule contribution to the global economy and its lack of both resources and cultural resolve, has become irrelevant to both the Euro-Zone and the markets.

Like Europe, the US fiscal situation is also a work in progress. We view it as the next "Big Story" to be digested by the markets. Some say it's China headed for a hard landing. While we see growth slowing in China, it's difficult for us to imagine an economy with so much surplus capital available not using it to cushion any significant contraction. For us, a "hard landing" for their economy is off the table. The most proximate concern for us is what happens in the US in 2012-2013. We're hopeful the November election can serve as the catalyst for progress made in formulating a budget that addresses the deficit without disrupting the recovery we currently enjoy. In the past three years, two bi-partisan commissions have recommended a solution that proposes a balanced approach of both tax and spending reform in addressing the deficit. Unfortunately, with both parties dug in during an election year, no one in Washington is listening and we anticipate little, if any, progress made until mid-2013.

We're hopeful that Greece serves as an example for the US and other fiscal miscreants who fail to understand that sustainable economies are those that exhibit fiscal discipline and accountability from their participants *and* their leaders. Too often, elected officials give the majority of voters what they ask for even if it's detrimental to the broader economy. An increasing number of voters are looking to government to provide "something for nothing" that's ultimately paid for by "the other guy". While Iceland and Ireland fell victim to credit-fueled speculation, the failure of Greece and other Club Med countries serve as examples of what happens when government employees and those on the dole outnumber "the other guys", as they eventually will.

These countries have reached the tipping point where democracy without discipline becomes antithetical to a sustainable economy. While the US is not yet there, the question at the forefront is whether we'll embrace our economic history or choose a path to a future similar to that of Greece or Spain. This philosophical conflict is center stage in the theater of the global economy and will overhang the debt and equities markets through the end of 2012 and beyond. Investors have diverted capital from Euro-centric companies for good reason. For the present, we'll continue to benefit from investors' flight to quality and would expect the US indexes to be among the best performing of the global markets in 2012.

Beyond 2012

2013 is a question mark for investors. Elections in the US and Europe and regime change in China will weigh heavily on future policy decisions made on all three fronts of the global economy.

The US: Failure by Congress to act on the deficit has already triggered tax increases and spending cuts that will take effect in December. The cost of Obama's "Affordable Care Act" will impact the economy as well in 2013. As of today, we predict the current administration will retain the White House while Republicans add a majority in the Senate to the one they currently hold in the House. If that proves to be the case, we would expect to see some progress made toward a compromise over Entitlements and Taxes in addressing the long-term trajectory of the budget deficit. We think the markets would approve of any legislation that's sets a course for sustainability but that could be offset by concerns regarding fiscal drag from increased taxes and healthcare costs.

Europe: Elections this year in France, Italy, and Greece will serve as referendums on the ECB's plan for returning those countries to sustainability. Barring any surprises, we would expect Sarkozy and Monti to remain in power. We view that as bullish for the Euro and the global economy since stability in France and the new paradigm in Italy are essential to the long-term success of the Euro-zone. Spain and Portugal won't hold presidential elections until 2015 but mid-term elections could prove unsettling if deficit targets are missed. The May parliamentary elections in Greece will likely affirm its membership in the Euro-Zone and agreement to submit to the ECB's fiscal authority. That could change in 2013.

China: As the world's second-largest and fastest growing major economy, China may not be steering the global economy but it controls the brake and accelerator. A scheduled change of leadership in the Central Committee is imminent. It's not known whether its currently hawkish stance toward inflation can persist in the face of a need to balance the demands of an increasingly vocal populace clamoring for jobs against the risk of creating asset bubbles that would threaten a hard landing for even the best of centrally managed economies. We think they're up to the task of successfully stimulating and managing the internal growth of consumer markets at the same time exports to Europe are slowing. The latter could provide an unintended assist to controlling inflation and set the stage for a ramp-up in growth 2-5 years out.

Our view underscores how policy-dependent the markets are likely to be for the next several years. It's a "damned if they do" and "damned if they don't" environment for the global economy. Taking steps to assure long-term sustainability requires the political will to de-leverage (US, Europe) or control inflation (China) in the short-term. Both policy initiatives will impart "fiscal drag" on the global economy for at least the next several years. Failure to do the "right thing" now will simply assure that a number of countries will hit the edge of the cliff someday at full speed. With failure not being an option, we maintain our view that policy-makers will, whether intentionally or not, deliver discipline to the marketplace. The recovery will continue but at a pace reminiscent of the late 70's: lengthy, uneven, and sometimes in doubt.

Last But Not Least

Speaking of recovery, the Economic Research Cycle Institute ("ECRI") said last September 21st that a recession was imminent in the US. We disagreed, relying on the data that indicated otherwise and ignoring the stock market's signal that the sky was falling. ECRI has an admirable, decades-long track record but after six months we have to say they whiffed on this one. We thought that it had to be more than just a coincidence that they made the call at the market lows of Q3. We believed that stock market direction volatility must be a weighted component of the model used as the basis for their predictions. They denied that stock prices were a factor but a group of number crunchers went to work and found a high correlation between stock market direction and ECRI's recession calls. In fact, without disparaging ECRI's good work, it was announced that their calls generally *lagged* the S&P 500 as an indicator of recession.

In this case both the stock market *and* ECRI got it wrong. This is a great lesson for investors. The markets succumbed to the Fear Trade surrounding something that *could* happen but didn't, while ignoring data pointing to what *was* occurring in the global economy. We were especially amused by several articles we saw linking the fall of Greece to the destruction of the global financial system. It sells papers but makes for poor economic forecasting. Experts have yet to find a leading indicator of recession that doesn't emit false positives. That means that no model is perfect, including that of ECRI. The false positive emitted by their model wasn't the first and it was linked to the false positive coming from the stock market. Pity those investors who folded their portfolios as a result of either. It was just 14 days later that the market embarked on a continuation of a bull market that began in April of 2009.

Will there be another recession? You bet. In fact, we guarantee it. When and how it will occur is another question. We'd have to see global growth slow dramatically as a result of a major liquidity event or geo-political crisis. A disappointing earnings season, as currently predicted, would also be cause for concern if it coincided with sour economic data. Greece has effectively failed but any contagion spreading from Spain to Italy could erode confidence to the point of creating a self-fulfilling prophecy of recession. Any of these taken alone or in combination could trigger the next one. We've experienced 11 recessions since 1948 with 2008 being the worst in our lifetime. Most have followed major expansions that created out-sized misallocations of capital i.e. asset bubbles. While some have been the product of event risk, rarely do we see a recession occur in the midst of a recovery supported by a large body of positive economic data. ECRI maintains its view but we see them being early and, in our business, being six months early is the same as being wrong. We've had some experience there as well. It happens to the best of us.