

# ECONOMIC REVIEW

January 26, 2012

## What We Thought

In early 2011 expectations for U.S. economic growth centered on 2.5%; a rate believed by the Fed to be the economy's potential rate of growth. Such expectations were not considered disappointing, but rather, after the financial crises and "Great Recession" of 2008-2009, were considered reasonable and satisfactory.

Amid these expectations, interest rates moved higher during the early months of the year with 2 year rates reaching almost 1.0% and the 10 year rising to 3.75%. Equity markets were in rally mode due to rising profits and rising confidence in the economic expansion. By early May the DOW30 had risen 11% to its yearly intraday high of 12,875 while the S&P500 lagged with only a 5.0% gain to its 2011 high of 1371. Meanwhile, Europe remained on everyone's radar but it was generally thought that the ECB and other official institutions would be able to contain the Greek debt crises and subsequently move on.

## But, Who Knew?

No surprise then, as so often is the case, that things did not turn out as expected. U.S. growth was disappointing, averaging just 1.2% in the first three quarters. Only modest improvement in the labor market weighed down consumer confidence while housing sector weakness dragged on and higher energy prices absorbed consumer expenditures away from other discretionary spending. The devastating Tohoku earthquake, tsunami and nuclear meltdown led to global supply chain disruptions while the Arab Spring across the Middle East and North Africa brought about broad geopolitical changes.

Slower growth, Washington budget gridlock, the S&P downgrade of the U.S. to AA+ and renewed concern over Europe led to a summer swoon in equities and record volatility. The DOW30 posted gains or losses of over 400 points for an unprecedented four consecutive days in August. By early October, the DOW30 had fallen 16% from the May highs to the year low at 10,809 while the S&P500 recorded an almost 22% plunge to 1075.

All this volatility was positive for bond prices as global money flows showed that investors still viewed the U.S. as the safest credit regardless of the S&P downgrade. Also supporting bond prices was the Fed's unprecedented August statement that they would keep rates low until at least mid-2013. They followed this in September by announcing they would extend the duration of their balance sheet in an action dubbed by the market as "Operation Twist". As part of the operation, by mid-2012, the Fed will sell \$400 billion of Treasury securities with maturity of 3-years and shorter and purchase a similar amount of securities with a maturity of 6-years and longer. This crushed interest rates along the curve to record lows in late September (short bills to 0%, 2-years to 0.15% and 10-years to 1.67%).

And who knew that in early 2011 the "Greek Crises" would morph into the "European Sovereign Debt Crises"? Who knew that the viability of the single currency scheme would come into serious question? Who knew that for most of the latter half of the year we in the U.S. would awaken each morning to analyze events in Italian politics and debt markets

to gauge what might happen in our markets? And who could have predicted that in light of all the political, social, financial, environmental and weather related turmoil and all the volatility that these events created, that the S&P500 would close unchanged at 1258 (the smallest annual change since 1947)? For sure, this writer did not know.

### **What We Expect**

As we begin a new year, expectations seem generally similar to those of a year ago. Despite an expected jump in 4thQ'11 GDP to 3.0%, overall growth in 2011 is expected to be just 1.7%. For 2012, expectations are only a little higher at about 2.0%. Growth in the U.S. should be supported by manufacturing gains tied to low inventory levels and a housing market that is expected to, at least, stabilize. The economy should also be helped by a supportive interest rate environment tied to improvement in the financial sector (despite the need for banks to enhance capital ratios) as global Central Banks pump liquidity into the system and by high levels of liquidity on corporate balance sheets. The unemployment rate, which ended 2010 at 9.4%, ended 2011 at 8.5% which was lower than predicted at the start of the year. For 2012, further modest declines are expected towards 8.3%. Monetary policy will remain extremely accommodative with the Fed having just announced that they will likely keep official rates exceptionally low at least through late 2014. This is an extension of their previous commitment of mid-2013. It is also possible that, if the economy does not surprise to the upside, the Fed will announce, as soon as April, a QE3 in the amount of \$500 billion or more in mortgage securities in order to push 30-year U.S. mortgage rates down towards 3.0%. Meanwhile, fiscal policy will continue to contract, but at a slower pace than in 2011.

With interest rates low, the Fed pre-announcing its intentions, economic growth only modest, risks from Europe rising and further QE pending, we see only a limited risk for market rates to rise this year. In fact, notwithstanding a major policy error here or abroad, we expect the curve to flatten a little as the Fed keeps short rates anchored while longer term rates decline modestly as the Fed's commitment to keep rates low for a longer period will force investors into longer duration assets to pick up yield.

After gaining 5.5% in 2011, we expect the DOW30 to post a similar performance in the 5.0-8.0% range in 2012. Meanwhile, the S&P500, which lagged the DOW in 2011 and posted no gain, should outperform the DOW by 1.0-2.0%.

When compared to the Euro Zone, the U.S. outlook is far superior and should contribute to a somewhat weaker EUR. The Euro Zone will probably see a recession in 2012 and contract 0.5-1.0% as banks are forced to deleverage more aggressively than their U.S. counterparts. Meanwhile some sovereigns and many banks will remain dependent on the ECB for liquidity (like the 3 year liquidity injection recently announced) and for the outright rolling-over of debt. As opposed to the U.S., the unemployment rate in the Euro Zone will probably rise modestly from the current 10% level.

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