

## [TEAMThink 12-30-2011](#)

### 2012 Outlook

In many respects, I think it would be productive for us and our investors to pull a Rip Van Winkle next year. My confidence in our outlook is pretty high, but I think we are likely to endure an unpredictable journey to get there. Falling asleep for 12 months would probably be easier, but that would result in missing all the "fun"!

### Economy

Leading economic indicators from Economic Cycle Research Institute suggest that much of Europe is already in or entering recession, and that Germany and France are at risk of heading in that direction. The US is likely already in recession or will be in the near term. Emerging markets like China, India and Brazil are experiencing classic cyclical business cycle dynamics, as higher inflation rates drove tighter monetary policy, which resulted in inverted bond market yield curves, and now their economies are poised to slow significantly. Even Australia, which has gone without an official recession for 20 years, appears to be heading in that direction. It is possible that a global recession unfolds.

Of course, just forecasting a "recession" isn't being very specific, though very few firms are neither willing to stick their necks out to forecast any kind of recession, nor look at depth and duration. It is that latter question that we believe is a critical nuance as we look towards 2012. Not every recession has to be a horrific contraction like we faced in 2008. In fact, history shows that about 25% of recessions have been relatively short and shallow, 50% have been "normal", and about 25% have been sharp and prolonged - and often accompanied by a major financial crisis. If our expectation that policy makers across the globe will continue to respond to the economic weakness on a more proactive basis than we experienced in 2008, then we believe the risks of a deeper and more prolonged recession are low. However, the economy's weakness does make it more vulnerable to shocks, whether it is war with Iran that results in \$200 oil or any other kind of shock one can imagine.

### Financial Markets

At this point we believe that financial markets already discounted a shallow or normal recession with its significant declines in 2011. Large and mega cap US indexes were very resilient relative to smaller and mid cap stocks, as well as most international markets. From peak to trough, most global markets were down between 30%-40%, while US small and mid cap stocks were down about 30% and 28% respectively, from peak to trough. Economically sensitive sectors in the US like industrials, materials, and energy were down 28%, 32% and 33% from peak to trough.

Mega cap high quality US stocks, which in aggregate had been horrible for 10+ years, finally enjoyed a period of significant out performance. This is reflected in the fact that the Dow Jones Industrial Average was down about 19% peak to trough. However, that decline was due largely to financial and industrial stocks. Blue chip stocks like Johnson and Johnson (JNJ), Proctor and Gamble (PG), and IBM (IBM) were flat or even up during the period. Those stocks entered the year at very reasonable or even absolutely cheap valuation levels, so it makes sense that they could be more resilient during a bear market. In addition, their business profiles tend to be more defensive and hold up better during economic weakness - hence the label "high quality".

Industrial commodities also suffered significant declines from peak to trough: copper was down about 35%, WTI crude oil down about 34%, nickel was down 42%, and lead was down 40%. "Hard currencies" like the Australian and New Zealand dollars were down 15% and 16%, while emerging

market currencies like the Brazilian real and Mexican peso were down 27% and 19% versus the US dollar.

While these were not declines as severe as we witnessed in 2008, collectively they are what I would call being at "mini-2008" levels. As I've expressed over the past 6+ months in this blog, it would be historically weird for two crises to unfold in identical or even very similar fashions so closely together. I believe this is very logical, as a crisis so traumatic and severe as we experienced in 2008 will only naturally extend a very long shadow. For example, many of those who lived through the crash of 1929 and Great Depression were terribly, and logically, impacted by that experience and forever worried about the next crash or depression. More recently, many in the US called for a Monday crash nearly every time a weak Friday unfolded following the 1987 crash and its long shadow. I still read commentary from people who lived through that period who are still obviously impacted by the legacy.

I believe this back drop supports our thesis that a normal cyclical decline has already occurred in financial markets in anticipation of recession. An examination of history shows many examples where financial markets "bottom" at the very beginning of, or even before, a recession. That is precisely what we believe is likely to have occurred this cycle, though we recognize that substantial shocks to the economy could change this outlook.

Long term valuation metrics for the US stock market are back to what I would call "blah". Most stock market segments are not cheap on an absolute basis, but very cheap relative to bonds. This is also the case in many global markets, though some in Europe and emerging market countries have returned to absolutely cheap levels. We are in no way deviating from our long term outlook that the US stock market remains in a secular bear market. Our main deviation from consensus is that we've already experienced another cyclical bear market and are in the midst of the next cyclical bull market.

## **Bonds, Currencies and Governments**

It is difficult to discuss any outlook for bond and currency markets without discussing politics and governments. With the massive debt problems in the euro zone, UK, US and Japan, we believe massive government intervention in bond and currency markets is here to stay for some time. Whether it is price fixing interest rates, money printing, capital controls or trade wars, we expect the political environment to get increasingly more volatile. We believe the US dollar based global monetary system is in the early stages of its end, and that process is likely to be a protracted and messy one. This is complicated by the fact that most major western currencies and Japan are now being managed via central planning with a bias towards debasement as a way to confront the unsustainable debt loads.

The US Fed and ECB have already begun expanding their balance sheets in recent weeks in order to, as we would characterize it, proactively confront the banking and sovereign debt crisis in the euro zone. We expect that process to continue throughout 2012. In addition, we believe that policy makers will take things up a couple/few notches as co-incident economic data turns sour during the first half of the year. For example, US employment data should reverse its recent modest up tick, which in an election year is sure to stoke calls for action.

The 2012 US presidential election year is also of interest, of course. It appears that it is likely to be Romney vs. President Obama, which to me suggests much of the same economic reality as the 2008 election. That may sound weird, so let me explain. As I argued in 2008, both candidates were part of the establishment and would simply generate the same fiscal and monetary result from different approaches. I argued Obama would blow out the deficit through social program spending and have a hard time raising taxes, and that a McCain administration would do the same thing via

tax cuts and military spending. Ultimately, I expected the result from either to be money printing from the Fed and big budget deficits.

With the economy likely to remain weak or even poor for much of the election year, I'd expect much of the same in 2012. Any fiscal hawkishness is likely to be filled with election year bluster and rhetoric. When it comes to governing, I doubt either will look to raise taxes and cut spending dramatically during a period of elevated unemployment and a weak economy. Both appear to be part of the Keynesian establishment, which means that they are likely to continue down the path of what some call the Keynesian trap. Effectively, their promise for balancing the budget are forever kicked down the road as the economy is perpetually too weak to withstand the accompanying pain of those actions.

Just as a drug addict begins to go through withdrawal if they stop taking the drug, monetary stimulus and budget deficits are similar. As soon as a bout of fiscal austerity is implemented or monetary policy tightened, the economy will likely go through withdrawal. We've seen this in the summer of 2010 and 2011 as financial markets and the economy weakened as QE and QEII ended in the US. History suggests that politicians will continue to make decisions to try and triage the short term pain, which means more of the drug. Even well intentioned attempts can be crushed once the reality of austerity and withdrawal hit a society. Social unrest and political upheaval are typical under those circumstances, which is why politicians typically end up choosing to go back on the drug. Ultimately, the addict does so much harm with the drug that an overdose occurs. In financial markets and economics, this is what we've seen take place in countries like Iceland and Greece. Currency and bond markets enter a crisis phase which forces a choice between two bad options - painful restructuring and contraction, or hyperinflation.

For 2012, we believe it is too early to expect that kind of crisis. In fact, markets continue to reward what we believe to be the most destructive long term behavior. Currency and bond markets in countries with some of the worst long term problems have responded positively to money printing. One need look no further than interest rates and the strength of the Japanese yen as an example. The same applies to the US and UK, where interest rates are near record lows and currencies remain relatively stable. Ultimately, we expect this to change, but it may take some time for a crisis phase to be reached. Given the massive amounts of debt and problems, a crisis could erupt at any time, but our best guess is that we won't reach that point in 2012 - at least in the US.

## **Portfolio Positioning**

We remain positioned to benefit from what we see as the major cyclical trend. Based on our outlook, this means that we are early in a recession, but that financial markets have already discounted that development. Markets are in the process of a cyclical recovery, which will ultimately be followed by the economy doing the same. The long term structural problems of too much debt remain intact, but those are likely to be a reality for years to come, as policy makers continue to revert back to the monetary and fiscal drug with any substantial pain. We believe that the US Fed already flinched with its Twist policy in late summer, and its coordinated policies with the ECB this fall. They are likely to continue following the play book Ben Bernanke has laid out throughout his academic career. Governments from Australia to China to the US to Brazil are likely to continue to shift towards stimulus as the 1st half of the year unfolds.

Of course, we could be wrong and another wave of a cyclical downturn could commence, in which case another version of a 2008-esque crisis would likely unfold. If that does occur, then our current portfolio positioning will likely be painful for as long as we maintain it. I'd hope we will begin to see signs in markets that such a scenario is unfolding and we'd be able to react accordingly, but obviously that is highly uncertain.

If the scenario I've laid out does play out, or at least relatively close, we expect the following:

1. Global stock markets will do reasonably well, and very well relative to bond markets. International markets are likely to outperform the US market - probably in local currency terms but more likely in US dollar terms.
2. Global bond markets are likely to generate little in the way of returns and would probably be vulnerable to modest losses. Government intervention would probably prevent a full out pounding on bonds (unless an all out crisis emerges.)
3. Commodity markets should build a base as they recover and then possibly ignite as printing presses are cranked up to higher levels around the world.
4. Countries that are net savers and more vigilant with their finances would see their currencies strengthen versus those of the massively indebted countries like the US. For example, we think people should be more focused on how the US dollar does versus the northern European currencies or the Singapore dollar rather than the euro.

While our portfolio positioning was ok through the first 9 months of 2011, the 4th quarter has been miserable. I remember feeling much the same way in late 2007, as we had structured portfolios for a recession and major bear market in stocks. The last day of the year I felt like an idiot for having done so, and then a short 3 weeks later felt much better about our positioning. In all honesty, I think the current backdrop is much more complicated and challenging than in late 2007, so we are less likely to fight market conditions if we see things begin to discount a scenario that is different than what we expect.

Therefore, we continue focus on companies whose businesses are leveraged to the price of many commodities, with oil, coal, many agricultural commodities, gold and silver being areas we have significant exposure. We also have exposure to non-US dollar currencies.

Our wildcard for the year is Japan, as we believe that 2012 may finally be the year in which that country reaches a tipping point relative to its debt and currency. Ironically, we'd expect the early stages of a burgeoning crisis in Japan to be bullish for Japanese stocks, which remain amongst the cheapest in the world. If the yen finally begins to weaken and the Japanese bond yields begin to move higher, it would likely result in move into Japanese stocks, which are dramatically under owned globally and also within Japan. Ultimately, we expect a crisis in Japan to become so severe as to make stock positions questionable, but believe that point is out on the horizon and that there is likely to be a significant opportunity between now and then. Therefore, we continue to maintain modest exposure to Japan.

Ultimately, how we perform in 2012 will be the result of whether or not our outlook is reasonably accurate. If so, then we are likely to be in pretty good shape. If not or if markets makes sticking to our guns very difficult for a stretch, as they have in late 2011, then how we tactically navigate market conditions will be very important. While we remain confident in our outlook, we are also prepared to make changes when and if we deem it necessary.