Market Strategy Report
Current Market Perspective

Anemic growth across major geographies and a deepening sovereign debt crisis in Europe reignited concerns of a global slowdown. In 2011 investors responded by rotating into U.S. debt and equities and out of higher-risk emerging markets, underscoring the relatively better standing of the U.S. economy and the strength of U.S. corporate balance sheets. At year-end, the S&P closed flat while the Dow was up 6%, both outperforming all major equity markets. Currently, the S&P 500 trades at 11.8x 2012 operating EPS estimate of $106.81, below its 10-year average of 15.0x.

As we look ahead to 2012, fundamental issues remain. The international leverage problem may take a long while to resolve. And nearly five years since the term “sub-prime” infiltrated pop culture, the world still remains in the earlier stages of addressing its debt burdens. This reality will continue to limit near-term growth and sustain complaints of economic stagnation. Elevated political acrimony is also likely to be a constant in 2012. In essence, this mixture of financial ambiguity and poor leadership will continue to foster capital market volatility and place pressure on valuation multiples for risk assets.

As such, while the global debt reckoning continues, the MWR research department anticipates that stock prices are unlikely to mark major advances from here, but they won’t fall apart either. Volatility will be with us for some time, punctuated by unexpected flare ups. Investors concerned about earnings sustainability and the macro picture will probably pay less for securities, keeping multiples compressed.

Similar to equity markets, we believe oil will stay in a trading range. The U.S. dollar is likely to remain a safe haven during times of financial stress. And, we still have no interest in gold and silver as sound, long-term investments.

In the U.S. we anticipate companies will cautiously add to payrolls and replace capital goods. The housing market will continue with the bottoming process, with another significant leg down in this area unlikely. While timing remains uncertain, we view the financial crisis in Europe as resolvable. The costs of an EU break up greatly outweigh locating a solution, no matter how politically unpalatable. A fix will arrive, the Euro will hold together, and the union may actually be better off as a consequence of going through this exercise.

Major risks to our range bound thesis include a reversal in encouraging U.S. unemployment trends and a collapse in China, among others. Since China’s arrival at the World Trade Organization a decade ago, growth has been profound. But signs of a lending bubble have surfaced. The consequences of a hard landing have the potential to touch each asset class across the globe. The European situation may also end up being worse than we think, increasing the odds of another recession. International unrest in the Middle East and other parts of the world also has the potential to disrupt our view. Iraq may quickly devolve into a civil war and a nuclear armed Iran has the potential to create turmoil in the region wanting for peace. Finally, the financial crisis could boomerang back towards America – this time targeting the government. An immediate, forced resolution to the U.S. debt problems is an unpleasant thought and would probably place upward pressure on rates at a time when financial burdens remain stressful. In that event, long-term fixed income investors would suffer.

With that in mind, we remain partial to larger, established companies that pay dividends and have lower degrees of revenue and operating income variation. Additionally, stocks that are out of favor – for the wrong reasons – and come with good long-term fundamentals, a clear valuation argument and a reasonable degree of downside price protection will also find a place in our portfolio. And, we will use pronounced selloffs and controversy as entrees for position building. Industry weightings aren't of huge importance.

As always, the heart of our investment process remains the same: Taking a long-term, balanced view of things with decisions dictated by fundamentals and valuation – not the news flow that seems to change each day. In general, we think the current environment makes for tough decisions on how to put money to work. Last year, the department became active with investment recommendations at times that felt acutely unpleasant. The same is likely to be the case this year, too.

Overall, this year will likely require a blend of patience and courage to get ahead. And we also recommend above average levels of cash on hand to preserve option value should opportunities unexpectedly present themselves.

- MWR Research

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