



The year 2011 began with strong expectations for above-trend growth, pushing equities and interest rates higher and resulting in a significant contraction of credit spreads. By mid-year, growth projections were pared back due to a surge in commodity prices (namely oil) and the worse-than-expected supply disruptions emanating from the earthquake in Japan. At the same time, the Euro-sovereign crisis moved beyond the smaller peripheral countries to Spain and Italy, threatening the core and presenting a contagion and systemic risk to the banking sector. An absence of decisive and credible actions by European leaders exacerbated the situation. In the fall, political gridlock in the U.S. produced a near-crisis as Congress played a game of political chicken with the debt ceiling debate. Shortly thereafter and partially as a result, the U.S. lost its AAA rating, downgraded by S&P to AA+ with a negative

outlook. Next, with the economy looking more vulnerable, the Federal Reserve took another step in its unconventional accommodating measures by initiating "Operation Twist" as opposed to another round of explicit balance sheet expansion. All in, given the rolling crises, the volatile trading ranges in yields and higher credit spreads were surpassed only by recent periods of financial crisis in the U.S. In hindsight, given this volatility, it is not surprising that investors were not well rewarded for taking on additional risk relative to the market. In contrast to the 2009-2010 period when the higher risk/less liquid sectors outperformed (i.e., CMBS, high-yield, emerging markets), in 2011 the same risk sectors underperformed and U.S. government securities outperformed, particularly those with longer-dated maturities.

Greg Cobb, Senior Vice President

## Fixed Income Outlook

After a disappointing growth environment in the first half of 2011, our second half outlook was for moderate, albeit subpar economic growth, buoyed by a number of factors: a rebound in manufacturing post the Japanese supply shock; trend growth in consumer spending driven by a reversal of the negative effects of the commodity shock; stronger export growth fueled by the weaker dollar; and stronger-than-expected investment spending in front of the year-end expiration of accelerated depreciation allowances. In 2012, we expect growth rates centered on 2.0, slightly below the economy's likely growth potential of 2.5%. As in the latter half of 2011, we expect positive contributions from a number of sectors as opposed to a single major contributor dominating the expansion. One benefit of below-trend growth and the significant amount of slack in the economy is that a rise in inflationary pressures is less likely. Overall core inflation should fluctuate around 2.0%.

Our outlook is built on the premise that consumer spending will be a positive for economic growth. The pace of job growth has been disappointing given the structural changes in the labor markets (e.g., mismatched skills, and reduced mobility). However, we expect grudging improvement and as a result, marginal improvement in personal income levels that should support final demand. Corporations have near-record cash on their balance sheets so investment spending should remain supportive but below the double-digit gains in 2011. The pace of exports will remain positive but with a pullback given the impending recession in Europe and the corresponding slowdown in the emerging economies. Where we do see a continued drag is in the government sector. Federal spending will remain restrained for years to come in order to arrest the growth path of deficits and spending. At the state and local levels, falling property tax collections and fewer resources from the federal government will result in fairly aggressive spending cuts.

To support consumption, investment, and offset the fiscal drag, the Federal Reserve will remain accommodative. The Fed expects to be on hold through at least mid-2013 and possibly until 2014. With continued weakness in the housing market, it is very likely the Fed will embark on a third round of quantitative easing, targeting the mortgage market via open-market purchases.

The bear case for growth is based on potential policy mistakes. In the US, a failure to further extend the payroll tax cut and extended unemployment benefits beyond February would result in a fiscal tightening of more than 1.0% of GDP. In Europe, lack of a convincing fiscal solution and a realization of the ECB as a lender of last resort will depress confidence, lower asset prices and accelerate the deleveraging of bank assets. The bull case rests on a swift and credible solution of the Euro-sovereign crisis and a balanced U.S. fiscal remedy, with medium-term deficit reduction coupled with fiscal stimulus into next year.

Given the base case and the balance of risks, we expect 10-year interest rates to remain in the 1.50%-2.50% range. It will be difficult for rates to be sustained in the 2.50%-3.0% range given the downside risks to growth, particularly those resulting from the European debt crisis and potential financial sector contagion. At the same time, it will be difficult for rates to sustain levels in the 1.0%-1.50% range barring a recession in the U.S. and a significant reduction in inflation expectations.

We stress that even if rates remain ultimately range-bound, volatility within the range will be unusually high – for both interest rates and spreads across the primary risk sectors. Certainly, the fundamental dynamics of growth and inflation will drive volatility, but technical factors and frequent investor rebalancing will likely whipsaw the markets. The breadth and depth of the financial markets have deteriorated following the 2008 financial crisis. There are now fewer players on Wall Street and the survivors are currently reinventing themselves in response to heightened regulatory and capital constraints. At the same time, the asset management investor base continues to grow. In sum, there is a widening disparity between the size of the dealer's and the end user's balance sheet. With such a mismatch, liquidity will be an ongoing concern and heightened volatility a fact of life. Our goal with respect to the management of duration and risk sector exposures will be to identify the predominant trend within the ranges and to capture tactical opportunities at the extremes.

Greg Cobb, Senior Vice President

## International Outlook

### Europe

The sovereign debt crisis dominated European equity markets for most of 2011 and is likely to continue for some time. A pattern has emerged of over-optimism ahead of meetings by EU policymakers followed by disappointment when not enough appears to have been done to tackle the crisis. Investors need to be more realistic that finding solutions will take time and this will not be achieved in one EU Summit meeting. Promising progress has recently been made towards achieving greater long-term fiscal discipline. The European Central Bank has importantly eased liquidity tensions by offering 3-year tenders and reducing collateral requirements. It is still reluctant to be seen as lender of last resort but is expected to step up its securities markets buying program.

Despite Europe being the dominant global concern last year, its equity markets have fared better than many others with modest gains in the fourth quarter helping to reduce the loss for the year to 13.8% in US dollars. Non-euro countries significantly contributed, in particular the UK, which has continued to be seen as a relative safe haven as evidenced by its loss for the year of only 6.1% and the record lows of its long-term benchmark government bonds. Many challenges remain in 2012, not the least a heavy government bond auction calendar, a softening in economic numbers with the peripheral counties likely to suffer significant declines, and elections in both France and Germany. However, there remain many solid multinational shares in Europe with good income support.

### Asia

In Asia, the tsunami in Japan and flooding in Thailand have disrupted supply chains in a periodic of economic uncertainty. Concern has shifted from overheating to slowing growth. China's GDP could fall to 7%. Weaker manufacturing orders, due in part to

the faltering European economy, are joined by housing price declines estimated to reach 20-30% in major cities. Chinese authorities have already responded to the slowdown by cutting rates and easing reserve requirements. Consumer demand should remain firm in response to easier credit and the economy should return to 10% growth rates in the second half of 2012. Growth in EM Asia has been subdued due to conditions in China and Europe, but inflation is under control and monetary authorities have room to ease conditions. It is expected as China recovers so will Asia.

### Japan

In Japan the significant disruptions mentioned earlier have made it difficult to track the strength of the underlying economy. The November Industrial Production number was much weaker than expected. Recent government forecasts show a significant reduction in public spending despite the reconstruction efforts that were expected to boost to the economy. Even though industrial activity is expected to pick up, the GDP growth forecast for 2012 is a modest 1%.

### Latin America

Latin America economies appear to be holding up reasonably well aside from Brazil, which is experiencing weakness in both expenditure and production. A government policy response is expected to stimulate conditions, but there is not much scope for lowering rates.

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## Equity Outlook

The U.S. stock market endured some of the wildest volatility in years during 2011 amid concern over surging sovereign debt in the U.S. and Europe. Despite finishing the year with a rally, the S&P 500 Index ended the year about where it started. Defensive sectors including Utilities, Consumer Staples and Health Care outperformed the broader market for most of the year. However, more cyclical sectors like Energy, Industrials and Materials outperformed in the last quarter of the year, possibly providing an early sign of changes in sector leadership in 2012.

We believe the year-end bounce in U.S. equities was due to a change in the direction of leading economic indicators. For most of the 2nd and 3rd quarters, leading economic indicators around the world generally decelerated, suggesting weaker economic growth ahead. We began to see a positive turn in the majority of the leading indicators we follow during the fourth quarter and these indicators continued to improve through year end. This shift likely brought some optimism to investors' future growth expectations and a shift in preference away from defensive investments and into stocks that will benefit from an improving economic climate in the year ahead.

We believe that 2011's late-year pickup in global economic indicators will continue well into 2012, bringing along with it generally better economic headlines, including modest improvement in real GDP growth, employment, and corporate earnings growth. As long as the forward-looking economic data continues to improve, we believe this will provide a favorable backdrop for U.S. equities and we expect positive returns for the broader market in 2012. The major risks to this recovery include unexpected intensification of the debt crisis in Europe, instability in the Middle East and disruptions to global oil supply, and of course political gridlock in Washington D.C.

Economically sensitive stocks should benefit from an improving macroeconomic environment. Cyclical sectors such as Energy, Materials, Industrials, and Consumer Discretionary are poised to outperform in the upcoming year while defensive sectors like Utilities, Telecom, Consumer Staples and Healthcare will likely underperform.

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