Market Review and Outlook—January 4, 2012

US and Europe and Emerging Markets—Three Different Paths In 2011 these three regions produced far different economic results. The US economy began the year inching along, and despite a high level of uncertainty, ended the year growing at a steady rate. Europe began the year inching along, but through their failure to address their sovereign debt crisis, the crisis has expanded, and their entire economy appears about to cross into a recession. Emerging economies in Asia and elsewhere began the year growing strongly. So strongly, in fact, that several of their central banks began to apply the breaks, raising rates to slow growth to 'only the high single digits.' "It's the economy, stupid" ruled 2011, as the two regions with slowing economic growth fared far worse. In light of the declines in European stocks (-15%) and emerging markets stocks (-20%), the US stocks decline of -4% or less is almost celebration-worthy.

In 2011 investors understandably focused on alternatives to stocks. Cash (money markets) continued to provide near zero income. Bonds had a profitable year, across the board. Long-term Government bonds leapt over 30%, due to two dramatic developments. The ever-active Fed began buying long-term Treasuries, driving prices up and yields down. Just as significantly, as the European sovereign debt crisis deepened this year, global investors again sought 'safe haven,' and incredibly US government bonds are their preferred haven, driving up bond prices further.

Municipal bonds rose from the dead, or more accurately, the reports of municipal bonds' demise was overstated. A noted municipal bond analyst, Meredith Whitney, in December 2010 predicted "hundreds of billions of dollars" of defaults in 2011. This caused a sharp exodus from muni bonds in late 2010, driving prices down and yields up. Oops. As the year unfolded sanity returned to the markets, driving prices up. The average intermediate-term muni bond fund gained 9% in 2011. High yield bonds, despite a strong 4th quarter, gained less than +3% in 2011, as investors remain cautious with all 'risk assets.'

Real estate funds fared well in 2011, helped by a red-hot 4th quarter. Commercial real estate companies are well-financed, and a growing economy produces a growing flow of rents, and shrinking vacancy rates. Natural resource funds did not do so well, hurt by engineered slowdown in the emerging markets, and un-engineered slowdown in Europe. In 2011, precious metals (including gold) reversed course, and fell over 20%. Similarly, technology took a hit in 2011, falling over 7%.

It is a good thing that bonds provided gains in 2011—this helped soften the blow to investors' falling stocks. It is also very good that the fourth quarter brought recovery to US stock markets—otherwise the Past Year column, below, would be quite painful.

Category	3 Months	Past Year	3-Yr Avg	5-Yr Avg	10-Yr Avg
Fidelity Cash Reserves	+0.00%	+0.01%	+0.23%	+1.70%	+1.97%
Intermediate Term Bond	+1.31%	+5.84%	+9.22%	+5.63%	+5.21%
Intermediate Muni Bond	+2.17%	+9.01%	+7.51%	+4.55%	+4.45%
Large-Cap Stock	+11.09%	-1.33%	+13.17%	-1.00%	+2.59%
Mid-Cap Stock	+12.70%	-3.83%	+17.40%	+0.46%	+5.62%
Small-Cap Stock	+15.23%	-4.07%	+16.78%	+0.16%	+5.96%
Foreign Large-Cap Stock	+4.49%	-13.97%	+7.79%	-4.67%	+4.00%
Real Estate	+14.78%	+7.51%	+21.67%	-2.20%	+9.16%
Natural Resources	+10.98%	-13.97%	+15.18%	+2.26%	+12.55%
Science/Technology	+6.15%	-7.62%	+21.54%	+2.74%	+2.31%
Moderate Allocation	+6.68%	-0.11%	+11.54%	+1.32%	+3.92%

The data in this table comes from Morningstar and is as of December 31, 2011.
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Regardless of how painful, each January, I review the accuracy of my predictions for the past year, and then share my predictions for the upcoming year. On January 10, 2011, the MARKET REVIEW AND OUTLOOK forecasted that 2011 would bring another year of stock market recovery. Specifically, I expected that all broad stock categories would rise 5% or more, value would outperform growth, real estate would rise more than 6%, foreign bonds provide only modest returns, and high-yield bonds would outperform, rising 6% or more. I presented a gameplan for a volatile year—and this plan likely served you well if you followed it.

Most of my 2011 predictions were wrong. None of the three major stock categories rose 5% or more, with foreign stocks plummeting 14%. Value did outperform growth, by falling less. Real estate did gain more than 6%, however this was the second and last accurate call. US bonds did better than I expected, high yield bonds did not meet expectations, and foreign bonds also underperformed. I was correct in only two of the seven open-ended calls (rising X% or more). I was correct on my value/growth call, as value modestly outperformed growth in 2011.

Sector	2011 Prediction	2011 Actual	2012 Prediction
Large-Cap US Stocks	Up 8% or more	-1.3%	Up 10% or more
Smaller US Stocks	Up 5% or more	-4.1%	Up 7% or more
Non-US Stocks	Up 8% or more	-14.0%	Up 7% or more
Growth vs Value	Value outperforms Growth	Value –2.1%, Growth –3.0%	Don’t know
Real Estate	Up 6% or more	+7.5%	Up 6% or more
General Bonds	Up no more than 4%	+5.8%	Up less than 5%
High-yield bonds	Up 6% or more	+2.8%	Up 7% or more
Non-US bonds	Up 5% or more	+3.3%	Don’t know

2012 Predictions—My primary theme for 2012 is for stocks to sharply outperform bonds, due to increased certainty. Europe has dithered for over twenty months—I expect that during 2012 we will finally see the path that Europe has chosen to move forward with its countries’ sovereign debt. I know (almost certainly) that by the end of 2012 we will know who will serve as President from 2013-2016, and the makeup of Congress for two years, and this will help investors understand the most likely policy changes on the horizon. Uncertainty has been the primary driver of investor’s insatiable appetite for bonds over the past three-plus years. With a sharply increased level of certainty, I expect investors to abandon 3% yields for 30-year Treasuries and 2% yields for 20-year Treasuries, and shift the money from these sales into stocks yielding 2.5% or more, in growing sectors.

This has the potential to snowball, as consumer confidence leads to a strengthening housing market, and an increasing flow of corporate hiring, which in turn boosts consumer confidence. These factors uniformly benefit ’risk assets,’ not only stocks but also economically sensitive investments such as high-yield bonds. The primary victim of this environment are bonds, with set, low, interest rates and likely falling prices, increasing the pain. While this may not fully unfold in 2012, I expect this shift of investor emphasis from bonds to stocks to show up prior to year-end.

Note that in the table above I ‘punt’ on the issue of growth versus value, and on the direction of foreign bonds. Value stocks have become very difficult to analyze, given their inclusion of financial stocks. From 2008 forward, the financial crises have hammered financial stocks globally, and I simply have no confidence in my ability to see when financials will no longer include land mines. Similarly, foreign bond results are highly dependent on currency moves, and for US investors this means the direction of the US dollar. This, in turn, is affected by global investors need for safety, and this is a factor that I have consistently been unable to predict. Thus my guess is as good as yours.

While I expect increased certainty from Europe in 2012, today there are many divergent paths they could select. European stock prices today are quite low—having built the possibility of several doomsday scenarios. I find it more likely that a ’middle path’ is taken, and that a bounce-back in 2012 is probable. The European economy is expected to slip into a recession this year, but its depth and duration should be limited, and regardless this is already well-represented in the low levels of their stock prices. Positive surprises in Europe are much more likely in 2012, given the grim current sentiment.

Emerging markets continue to be in an enviable position—they have economic growth, and they have ‘levers’ to adjust their economies up and down. In the US, we have used all of our ammunition, and have very few tricks left up our sleeve to boost our own economy. I expect valuation-driven gains from emerging markets in 2012—bounce-back movement more than stock market gains driven by unexpectedly positive economic news.

Certainly my predictions can be wrong, as they were in 2011. However, even if investors remain cautious throughout 2012, stock and high-yield bond investors in 2012 should enjoy strong dividend/interest payments, compensating them well for their patience.