January 2012

It's the Economy!

Without question, 2011 was an extraordinarily difficult year for many investors, including us. It was a year where market truisms and economic fundamentals either did not hold or were ignored. While stock market volatility was extreme, equity indices ended the year generally flat. In fixed income, the big story was the incredible treasury rally and the poor performance of everything else. Many treasury yields closed at all time lows in September including the two year at 0.15% and the ten year at 1.71%.

Why the low yields? Europe! In August, the market became fixated on events overseas centered on Greece. The business media reported a plethora of negative news that many thought was the beginning of a Lehman-like event. While we disagree, we also found ourselves following the most routine of European news. Even my wife, who has little background and even less interest in financial matters, asked me over the holidays, "What's up with Greece?"

Clearly, her comment was evidence that even the masses were aware of the story. But, one could argue that the story was over reported. Looking at the chart below, the 17 nation Euro Area represented just over 16% of 2010's $75 trillion global GDP. One might ask "why all the panic" since Greece only contributes the equivalent output of Maryland. Even the three most worrisome countries in the news (Portugal, Ireland and Greece) combined are less than 1.0% of global GDP.

Top Ten Countries by Gross Domestic Product (GDP)

		2010 GDP ($Bn)	% Total World GDP
1.	United States	14,527	19.3%
2.	Euro Area	12,168	16.2%
3.	China	5,878	7.8%
4.	Japan	5,459	7.3%
5.	United Kingdom	2,250	3.0%
6.	Brazil	2,090	2.8%
7.	India	1,632	2.2%
8.	Canada	1,577	2.1%
9.	Russia	1,480	2.0%
10.	Australia	1,237	1.6%
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	Greece	305	0.4%
	Maryland	295	0.4%

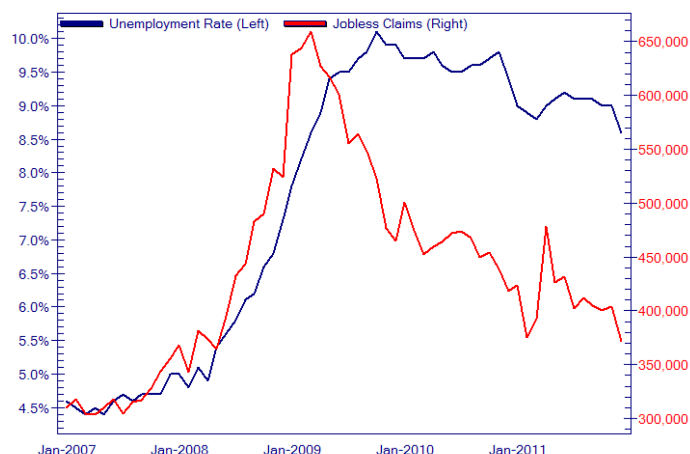
**Source: International Monetary Fund, World Economic Outlook Database, September 2011*

We expect continued normalization in Europe. But, it's taking time as Germany continues to extract concessions from European nations before "stepping up to the plate" to solve the crisis. In addition to monetary policy, Germany is now exercising authority on fiscal policy over much of Europe. All of this – and leadership changes in Portugal, Ireland, Greece, Italy and Spain – have come without any military intervention. Pretty amazing from a historical context!

Europe is responding to the crisis. Finance Ministers approved a rescue package of €780 billion creating the European Financial Stability Facility (EFSF). The EFSF provides financial assistance to European countries facing financial difficulty. Meanwhile, the European Central Bank (ECB) also coordinated dollar swap lines with the Federal Reserve and other central banks to insure liquidity in the markets. Finally, Long Term Refinancing Operations (LTRO) has been implemented lending €489 billion to 523 member banks. The loan term is three years at a rate of 1.0%. A second round is scheduled for February.

The LTRO sounds a lot like our Troubled Asset Relief Program (TARP) which had a $475 billion authorization with $315 billion invested in 707 financial institutions. And it's working!

With Europe stabilizing, the markets will soon revisit US economic fundamentals. After Lehman, the economy fell into a terrible tailspin. Now, we are rebounding from the troughs. Looking at jobs, the graph below shows the unemployment rate (blue) declining to 8.5% from a peak of 10.0% in late 2009. Confirming the favorable trend is weekly jobless claims (red) which have dropped to a four-week moving average of 373,000 from a peak of 652,000 over a similar time period.



**Source: Garcia Hamilton & Associates*

While job creation is critical to a recovery, other important statistics are also showing positive improvement including manufacturing, capacity utilization and record high S&P 500 Index profits.

From an economic standpoint, many Americans may long for the good times during the Clinton administration when the unemployment rate hit a low of 3.8% and GDP reached a high of 5.4%. During the 1992 Presidential election, one of Clinton's key strategists James Carville always said, "It's the economy stupid." In 2012, market practitioners will soon appreciate that wisdom. When they do and as the story gets media attention, we expect 2012 to deliver higher treasury yields, higher stock prices and strong outperformance from spread product led by corporate bonds, particularly financials.

Lastly, thanks to our clients and employees for a successful 2011; and here's to a great 2012!

Gilbert A. Garcia, CFA
Managing Partner
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A copy of our Form ADV, Part II is available upon request.
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