

*The double-barreled benefits of falling inflation should keep the outlook for the US economy improving through at least the first half of 2012. Stock prices should rise along with the improving outlook.*

### Back from the Brink

It appears the beating that stock markets delivered in the third quarter of 2011 had the desired effect: Namely, getting the political leadership of the developed world to pull their heads out of the sand, if only part of the way.

European leaders got serious about the liquidity and solvency crisis threatening the Eurozone, as the European Central Bank (ECB) took forceful steps to insure the continued funding and functioning of their financial system. While heading off the near-term liquidity crisis won't solve longer-term solvency problems, it helped indirectly while also giving Greece, Italy, Spain *et al* much-needed time to address their structural debt issues.

In the US the punishing message from the markets was amplified by the Occupy Wall Street movement, whose focus on unemployment and wealth inequality helped shift the national conversation away from its obsession with debt reduction and toward the topics of jobs and economic growth.

This was particularly evident in the congressional showdown over extending the federal payroll tax cuts implemented in 2011. House Republicans resisted extending the cuts until it became obvious they were committing political suicide. 160 million Americans stood to benefit from an extension of this temporary tax cut. That's a lot of potential demand to withhold from a weak economy. And it's a lot of votes to put at risk.

These glimmers of political sanity, however small, helped pull investors back from the brink: After falling 14% in the third quarter of 2011, the S&P 500 rose 12% in the fourth quarter.

This was enough to push the S&P (barely) into the black for the year with a total return of 2%. Virtually all of this came in the form of dividends. The S&P's price level on December 31, 2011 stood almost precisely where it was 12 months earlier

### Cyclical Tailwinds

Also helping during the fourth quarter, though with less fanfare, were the effects of falling headline inflation on consumer spending in the US and throughout the developed world. As we discussed last quarter, in our New Normal, slow-growth economy changes in headline inflation (think gas prices) have an outsized impact on overall levels of consumption and thus on overall economic activity.

In the first half of 2011 headline inflation was rising. This meant consumers had to spend more on fuel and less on everything else, which in turn meant sending more dollars abroad to oil producers and leaving less to spend stateside. The economy slowed and flirted with recession.

The upside to a slowing economy, however, is falling demand for fuel. So a slowing US economy (along with Europe and China) lowered demand for fuel, which brought down oil prices and thus prices at the pump. Lower prices at the pump meant more dollars available for US consumers to spend in the domestic economy. In this way, falling (or rising) headline inflation acts like a tax cut (or hike) for consumers, boosting (or limiting) US spending and thus the overall economy.

As we wrote last quarter, we expected falling fuel prices to have a stimulative effect on the US economy in the fourth quarter of 2011 or the first quarter of 2012.

continues on reverse

Major Market Performance 4th Quarter 2011

	4th Quarter 2011% chg.	2011 % chg.
DJIA	12.78	8.38
S&P 500 (large cap)	11.82	2.11
S&P 1000 (small/mid cap)	14.22	-0.92
S&P 1500 (all cap)	12.10	1.75
NASDAQ	7.86	-1.80
Barclays State G.O. Municipal Bond	2.25	10.74
Barclays Gov/Credit Intermediate Bonds	0.84	5.80

Happily, the earlier date proved correct as the US economy grew in the neighborhood of 4% in real terms during the fourth quarter.

### Knock-On Effects: China

Falling global inflation is also producing beneficial secondary effects elsewhere, most notably in China. There the fast-growing economy had caused inflation to rise to levels unacceptable to the Chinese Government, which set about to cool the Chinese economy by various means of restricting liquidity. This led the Chinese economy to slow in 2011 along with the economies of Europe and the US.

Falling global inflation, particularly in food and fuel prices, will now allow the Chinese Government to stimulate its economy, which in turn will generate demand for firms around the globe that sell into the Chinese market.

So, falling headline inflation has a double-barreled benefit for the US economy: It spurs consumer spending by leaving more discretionary dollars in consumers' pockets while also increasing global demand for US goods and services exported abroad.

We expect these double-barreled benefits of falling inflation to keep the outlook for the US economy improving through at least the first half of 2012 and quite possibly further. As the outlook for the US economy improves, stock prices should rise along with those improvements.

### A Political Digression

As we head deeper into the silly season of presidential politics, many investors will try to handicap the markets by reading the fortunes of various presidential candidates—as if the market “likes” one candidate and “dislikes” another. We’ve seen this repeatedly in reports out of Wall Street that put an Obama re-election as one of the key potential negatives for the stock market. While a review of stock market history clearly refutes the notion that Republican presidents are better for stocks, this way of predicting markets and elections gets matters precisely backwards.

In the January 13 edition of the *Washington Post*, financial pundit Barry Ritholtz explains how in his article, “The Markets Don’t Care How You Vote.” I paraphrase: If the economy is doing well or improving significantly, this both spurs the stock market and increases the odds that the incumbent will win re-election.

If the economy is doing poorly or faltering, this takes the air out of stock prices while raising the odds of the challenging candidate’s election.

The market doesn’t like or dislike a particular party or candidate. It likes or dislikes a particular economic outlook and that outlook has direct bearing on who will win the election: the incumbent or the challenger. Notice there is no reference to which party the incumbent or the challenger belongs to. As James Carville so famously said of presidential politics: It’s the economy, stupid.

On this common-sense theory, our outlook for an improving US economy through at least mid-year would seem to give an edge to the incumbent.

### What We’re Doing

In our last quarterly Market Outlook we said we expected the economic outlook to improve and that we were prepared to shift our portfolio posture from defense to offense. This we did in two separate moves during the quarter. We first shifted our asset allocation from an underweight of equities to a neutral weight. As our confidence in the improving outlook grew, we shifted our equity exposure again from neutral to overweight.

Concurrent with this shift in asset allocation, we also moved our sector emphasis away from the counter-cyclical consumer staples and utilities (classic defensive stocks) and toward the pro-cyclical technology, energy and industrial names that should benefit most from an improving economy.

We should say in closing that our shift to a more aggressive posture should not be taken to reflect a Pollyanna-ish optimism about the risks in Europe. The problems in Europe are real, structural and far from resolved. They are, however, perhaps the most well signaled risks in history, which is to say they are priced into the market. Stocks tend to be priced at the margin, that is by a *change* in investor outlook, whether for better or worse. We believe the overwhelming focus on Europe and its potential risks has created an opportunity for an improving US picture to lift stocks substantially. That is, today we think the surprises are likely to be on the upside.

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