It's All About Europe... For Now

What a year 2011 has been for the U.S. stock market. For the first four months of 2011, the market was up 9 percent. This rally was followed by a 19 percent selloff over the next five months. Since early October, the market has rallied 15 percent through year-end. We have certainly covered a lot of ground to end the year, up only 2 percent for the year.

For better or worse, much of the volatility in the market over the last six months has been driven by the daily news out of Europe. To oversimplify the situation, positive news flow from Europe has led to rallies in the U.S. while negative news has resulted in down days. In addition, the news flow from Europe has caused the U.S. markets to be quite volatile. In 2011, there have been 14 trading days in which the S&P 500 Index has moved up or down by more than 2 percent in a single day.

As we all know, the European Union (EU) countries are struggling to address the sovereign debt crisis that many are now experiencing. Throughout the year, Greece and Italy have dominated the European news. Greece's debt-to-GDP ratio is currently 165 percent and Italy's ratio is 112 percent. Germany, in contrast, has a debt-to-GDP ratio of only 43 percent.

While Italy's debt-to-GDP ratio is not as severe as Greece's, we worry about Italy even more. Italy is the fourth largest country in the EU, while Greece is only the 12th largest. As a result, many analysts consider Italy as "too big to fail" because the repercussions of an Italian default could be tremendous. In addition, the European Central Bank (ECB) probably doesn't have the resources for a large bailout and German politicians don't have the desire to support the weaker EU members.

In the interim, the bond market has certainly demonstrated some concern. The yield on 10-year Greek bonds has increased from 10 percent in February to as high as 33 percent in December, while the yield for 10-year Italian bonds has increased from 4.5 percent in February to as high as 7.5 percent in November. In other words, Greek bonds are priced for default while Italian bonds are signaling risk.

Given the debt levels in both countries, yields at these high levels are not sustainable. The numbers just don't work. Think about the simple math: if Italy is paying 7.5 percent interest on its debt (assume that its debt is 100% of GDP), Italians are paying interest that is 7.5 percent of GDP. Italy's tax revenue is only 22 percent of GDP. In other words, more than one-third of its tax revenue will be used to pay interest!

Recent news out of Europe has been more encouraging. The EU countries met in early December and announced that they agreed on a long-term plan requiring each EU country to effectively balance their budget each year. If an EU country violates the balanced budget measure, automatic sanctions (yet to be determined) will be imposed.

While this agreement sounds ideal in theory, this plan has many potential obstacles that must be overcome in order for this plan to work. These obstacles include:

- It is unlikely that all EU countries will be able to muster the political support for a balanced budget.

- Even if countries do agree to balance their budgets, it will be politically difficult to implement austerity measures. These measures will likely result in government layoffs, cutting retirement benefits and a significant recession.

- Even if all countries agree to balance their budgets, it is uncertain whether the EU will actually impose sanctions on those countries which violate the terms. As we have seen with Greece, even a small violator can cause huge problems since much of their sovereign debt is owned by banks throughout the EU.

There is tremendous uncertainty with the obstacles described above. This could eventually lead to some countries exiting the EU so that they can return to their own currency (and devalue it). There will be serious repercussions if a small country does this. But the repercussions would be tremendous if a larger country, such as Italy, were to exit the EU.

With all this said, the European Central Bank (ECB) has done its part to ease the current tension. The ECB has made significant below-market-rate loans to EU banks. The assumption is that these banks will buy sovereign debt and temporarily ease the problem. Of course, loaning money to an over-spender is only a temporary fix.

The bottom line is that these are long-term problems. It took a long time to arrive here and they're not going to exit this situation quickly. Ultimately, a few countries will most likely get kicked out of the EU (i.e. Greece). This may be a good thing since it could give the markets some clarity as to how the European sovereign debt crisis will stabilize itself. Until that time, the news out of Europe will likely continue to affect the U.S. markets more than we would like.

Attention May Shift to the U.S.

As described above, much of the market's focus is on Europe for now. However, once there is some clarity concerning Europe's debt situation, the market's attention may turn to our deficit/debt situation. Obviously, we have our own debt problems in the U.S. This fiscal year, our government incurred a $1.3 trillion deficit and next year's deficit is expected to be more than $1 trillion. Our federal government's debt-to-GDP ratio is currently 100% and increasing. While we are not Greece, this trend is a concern and will only get worse until our elected officials begin to make some difficult decisions.

Earlier this year Congress agreed to reduce our deficit spending by $2.4 trillion over the next 10 years. When this bill was passed, $900 billion of the $2.4 trillion in cuts were agreed upon. A debt "super committee" was then appointed to identify how to cut the remaining $1.5 trillion from the deficit. As we all know, this "super" committee was unable to reach an agreement.

This result was a huge disappointment. First, we simply kicked the can down the road once again. Second, it's particularly disappointing that our elected officials can't find $1.5 trillion of savings OVER 10 YEARS, when we have incurred a $1.3 trillion deficit for this year alone. Finally, the likelihood of a significant agreement in a major election year (2012) seems unlikely as partisanship is intense.

However, the U.S. continues to be fortunate from a fiscal perspective. We are able to borrow huge sums of money at low rates. As a result, we still have time to solve our problems.

Currently, Japan and China continue to buy more than 50 percent of our federal government's new bond issues. If Japan or especially China stops buying our debt, even incrementally, the only way we could entice other buyers to the table would be to offer higher, possibly much higher interest rates. Such an increase would likely spook the bond market. As we have seen in Greece and most recently Italy, spooking the bond market can be dangerous since the bond markets can take on a life of their own in a panic environment. Hopefully our politicians won't let us get to that point.

In the interim, the Federal Reserve (Fed) is doing everything it can to help. The Fed has effectively cut interest rates to 0 percent. Unlike the ECB, our Federal Reserve has the flexibility to print additional money to finance a portion of our debt. Over the past four years the Fed's balance sheet has increased by approximately $2 trillion from $800 billion four years ago to $2.8 trillion today. There is likely a limit to how much the Fed can leverage its balance sheet before global investors object. As a result, this financing approach may have reached its limit.

While we have time to act, the time is not unlimited. It is encouraging that our debt situation is becoming an issue that ordinary citizens are discussing. Obviously, this puts pressure on our politicians to act. The decisions that must be made concerning our entitlement programs (primarily Medicare and Social Security) are very difficult and will impact everyone. Will our politicians have the courage to make changes? It will be a lot less painful if we make these changes before the markets force us to make changes.

Where We Go From Here

While the U.S. clearly has long-term fiscal issues which need to be resolved, our economy and markets are fortunately in better shape than Europe's economy and markets. Some of the positive news about the U.S. include:

- First, most economists are forecasting below average but positive GDP growth for 2012, in the 2.0 percent to 2.5 percent range. While this is significantly below the long-term average of 3.5 percent, it is certainly better than the negative growth (recession) that is expected in Europe.

- Second, earnings growth for the S&P 500 companies is expected to be approximately 10 percent in 2012. While this is slower than the 16 percent growth that is expected for 2011, it is much higher than the long-term average of 6 percent earnings growth.

- Third, for better or worse, our federal government continues to have the ability to stimulate our economy with continued deficit spending. It is likely that the 2 percent payroll tax cut and the expanded unemployment benefit program will be extended for all of 2012. The cost of extending both of these programs is approximately $200 billion which analysts believe will add at least 1 percent to their 2012 GDP forecasts.

- Fourth, recent employment trends are encouraging. Over the last year the unemployment rate has decreased from 9.8 percent to 8.6 percent. Unfortunately, these numbers are a little misleading due to the fact that a significant number of Americans have quit looking for work and don't count as unemployed. But, we are moving in the right direction, even though it will be several years before we get our unemployment rate back below 6 percent.
- Fifth, most encouraging is the overall valuation of the market. The S&P 500 Index is currently trading at a price to earnings ratio of 13 based on 2011 earnings. That is well below the historical price to earnings ratio average of 16.

Given the trends outlined above, it is reasonable to expect the stock market to generate positive but below average returns in 2012. There will be more tail winds than head winds in the market. Assuming the U.S. avoids a double-dip recession (which it should) and the situation in Europe is contained, market conditions will continue to improve as we progress through 2012.

As it relates to the bond market, with interest rates at alltime lows, investors need to be particularly careful. Given our debt situation, it is likely that interest rates will begin to slowly increase in coming years. Given that outlook, investors should avoid stretching for yield by investing in longer-term bonds.

Unfortunately, investors should continue to expect the unexpected over the near term. Over time, the situation in Europe should resolve itself and the U.S. will eventually take the necessary steps to address our debt situation. While this process will likely take longer than many of us would like, we are hopeful that our leaders will begin the process sooner rather than later.

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