Outlook℠

Topics for today's investors

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The Murphy Wealth Management Group

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2012 Outlook: Investing at the crossroads

The following has been condensed from Wealth Management Research–Americas' 2012 Outlook. To obtain a copy of this report or discuss how its research might bear on your portfolio, please contact me.

With markets settling back to levels similar to that of 2011's open, we recommend a modest defensive bias going into the new year. As the fragile recovery continues, a narrow margin holds between expansion and recession, the brunt of deciding factors resting with policy choices and political leaders. Although risk assets are unlikely to meaningfully recover from their current relatively depressed valuations until sovereign and financial concerns abate, it may be a multi-year process until macroeconomic uncertainties dissipate. As 2012 begins, we are at economic, political and policy crossroads.

While new challenges are certain to develop, we see three trends born from the 2008-09 financial crisis that should interact and ultimately dictate financial market outcomes in 2012: 1) the deleveraging of global balance sheets, 2) continued political leadership changes, and 3) the simultaneous easing of monetary policy by major central banks.

Deleveraging: Although many consumers and U.S. banks began to cut back and recapitalize after the financial crisis, we expect to see the continued deleveraging of consumers, financial institutions and governments limit worldwide growth. Although overall household indebtedness and the ratio of household liabilities to disposable income have decreased since the crisis, consumers are unlikely to releverage their balance sheets rapidly and spending is expected to remain constrained given sluggish employment growth. In Europe, banks have not recapitalized themselves to the same extent as their U.S. counterparts. With private investors showing little interest in providing fresh capital, banks are likely to curb their lending in order to meet heightened capital requirements. This risks exacerbating the European recession. At the crux of the eurozone crisis rests the issue of public debt. While many countries have already

begun the deleveraging process, this continued trend of fiscal contraction in Europe should also limit growth.

Political change: Just as deleveraging should continue through this upcoming year, recent leadership changes (as evidenced in the Middle East, North Africa and Europe) are likely to extend through 2012 as well. In fact, these changes should impact some of the most strategically important countries in the world. The three countries/regions with upcoming elections likely to have the greatest potential effect on the global macroeconomic outlook are the U.S., Europe and China. In the U.S., if neither party can win decisive control of the political process, the country risks hitting gridlock at a time when fiscal reform is vital. For Europe, France's presidential election will coincide with ongoing concern over the country's AAA sovereign credit rating. Finally, although China's leadership changes are unlikely to be structurally transformative, its increasingly assertive role in world affairs begs a close following.

Central bank easing: Following the 2008 financial crisis, public sector intervention was successful in averting a modern day Great Depression. As the situation in the eurozone progresses, a similar involvement will be needed. This time it appears that only the central banks, with large enough balance sheets, can handle the situation. While the Federal Reserve has engineered the first and second rounds of quantitative easing and "operation twist," the European Central Bank has started to support European debt markets with its Securities Market Program purchases. Even emerging market economies—which had increased rates to fend off inflation threats during 2011—seem to be reversing course to a more accommodative stance. For the first time since the 2008 financial crisis, there is now a universal easing of monetary policy.

Investment recommendations: As far as investment strategy is concerned, we recommend holding an overall modest defensive bias as we wait to see how each of these trends plays out. Specifically, we opt to moderately underweight global equities and see a likely deceleration in global growth from the recession in Europe as reason to underweight commodities as well. Our overweights include bonds and cash.

Within equities we avoid the eurozone, preferring the U.S. and increasing our exposure to emerging markets. We view growth stocks, specifically within the technology, consumer staples and healthcare sectors as more attractive than value stocks.

In more general terms, we also favor income-generating investments as a way to find return amid choppy, rangebound markets. With bond yields across most fixed income markets still hovering near generational lows, the opportunities for producing income seem to have diminished, while the risks associated with those income streams have risen. In this context, we favor domestic high-yield corporate bonds and dividend growth stocks.

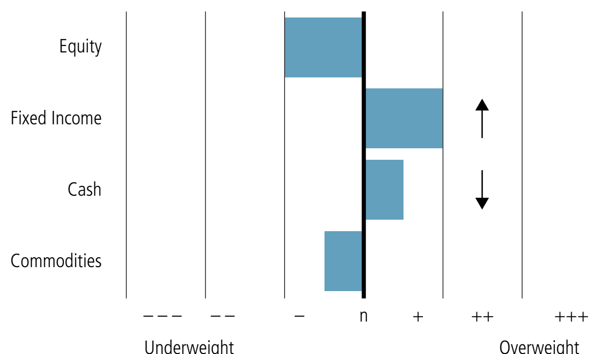
In an atypical environment, it's also important to think beyond the basic asset classes. We recommend thinking of volatility as an asset class and utilizing it by gaining exposure through derivatives. This can help both dampen volatility itself and supplement returns. Additionally, be sure to retain some flexibility and prepare for tactical repositioning throughout the year. We believe that it will be important to be willing to add risk to portfolios following phases of market decline and to trim positions following rallies.

Of course, there remain threats that may unhinge these recommendations. Our baseline forecasts and market outlook may quickly change with risks of an implosion in the eurozone, a hard landing in China, a double-dip recession with a third round of quantitative easing in the U.S., a conflict with Iran and overall escalating social unrest.

Although we enter the year with a modest defensive bias, we must be prepared to make changes as needed throughout the year. We are, after all, at a crossroads where both wisdom and will are certain to be tested in many ways. Should decision makers rise to the challenge, opportunities should emerge.

Asset class preferences

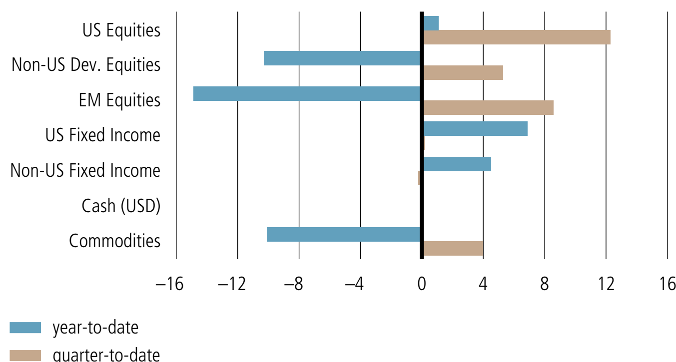
Tactical deviations from benchmark



Note: Black arrows indicate changes as of 7 December 2011.
Source: UBS WMR, as of 7 December 2011

Asset Classes

Total return in USD and %



Source: Bloomberg, UBS WMR, as of 6 December 2011

Investing *at the crossroads*

We bring you Wealth Management Research–Americas' annual listing of the 15 developments it believes will, may and won't happen in 2012.

Will

European sovereign credit quality will deteriorate. Sovereign credit quality will continue to deteriorate. While a potential Greek default would be the most dramatic illustration of this trend, a downgrade to France's sovereign credit rating could be the most impactful.

Global earnings growth will stall. We expect earnings growth to stall amid decelerating global GDP growth rates and tougher year-over-year comparisons. "Bottom-up" consensus estimates for the S&P 500 corporate profits are still too high at about $108 per share. We look for earnings to rise by only 0%–5% to $98.

Risk premiums will remain high. Given the challenging macro backdrop and uncertainty on the leadership front, we look for risk premiums to remain elevated. "Normalization" of risk premiums would likely require greater clarity with regard to the sustainability of the global economic expansion and clearer resolution of the fiscal challenges facing developed countries. Both appear unlikely.

Central banks will ease further. The major global central banks will be pursuing easier monetary policy conditions. While the pace and scope of policy actions will differ across regions, the overall mix will likely include expansions in central bank balance sheets and further reductions in base lending rates.

Economic growth prospects will "decouple." Global growth prospects will likely "decouple," with the U.S. and emerging markets continuing to expand even as Europe falls into a shallow recession. Economic shocks have tended to originate in the U.S. and then spread to Europe. The U.S. should continue to benefit from improving lending conditions, stabilization in the housing sector and some level of consumer reengagement.

May

Bank deleveraging may create a global credit crunch. With the economy poised for recession and prospects high for further deterioration in asset quality, European banks will need to shrink balance sheets. This could prompt a broader crunch amid a tightening of credit standards and pose a broader threat if the crunch expands beyond Europe.

Geopolitical tensions may lead to another energy shock. While oil prices have backed off, they remain elevated amid solid demand in Asia and tight inventory levels. There is a growing threat that a further escalation of tensions in the Middle East could prompt another energy shock, pushing oil prices above 2011 highs.

The eurozone may make decisive steps toward a fiscal union. Progress in addressing the fiscal crisis has been tentative, as few leaders have been willing to make the concessions necessary for a credible fiscal union. However, with German Chancellor Merkel having held firm on the need for reforms, the eurozone appears closer to a workable union.

U.S. capital expenditures may accelerate. Lack of conviction about the broader macro outlook has prompted CFOs to hoard cash in recent years. While a fair portion is likely to be returned to shareholders, we may see an acceleration in expenditures as well with corporate America still focused on raising productivity.

Crises may erupt in individual emerging market economies. The fallout from the fiscal crisis in Europe has done little more than dampen growth across emerging markets. But with the eurozone poised for recession, certain EM countries exposed to a deceleration of growth may be vulnerable to crisis.

Won't

U.S. will not achieve meaningful fiscal consolidation. The failure of the super committee to reach agreement on deficit reduction is proof that Washington has little appetite for fiscal austerity. Despite rules that would have made any agreement simpler to implement, the two sides were unable to find common ground.

China will not experience a hard landing. Fears that China is headed for a hard landing are overblown. While measures to deflate potential bubbles in the property market will dampen growth, we look for China to grow at an 8% clip in 2012.

Eurozone will not break up in 2012. The costs associated with dissolving the euro would be staggering, and reverting to domestic currencies would do little to solve the competitiveness plaguing the more vulnerable players. With steps being taken toward a fiscal union, the threat of a break-up of the euro has declined.

Social unrest will not subside. Global social unrest in 2011—such as Middle East violence and protest movements—is unlikely to subside quickly. The "Occupy" protests are likely to become a permanent feature of the political and social landscape.

The U.S. dollar will not lose its safe haven status. Rivals to the dollar will emerge, but we don't see serious contenders to the greenback. While some argue that the Swiss franc is a more stable store of wealth than the dollar, the size of the Swiss economy and the decision to link the franc to the euro suggest this is simply not a viable alternative to the dollar.

Looking back at 2011

A report card

In the spirit of accountability, Wealth Management Research–Americas offers this year-end report card on its "will, may, won't" list of 2011.

Will

Statement	Result
Equity markets will provide normalized returns.	✗
The sovereign debt crisis will grow more acute.	✓
Corporate cash hoarding will end.	✗
Geopolitical threats will intensify.	✓
Congress will deteriorate into gridlock.	✓

May

Statement	Result
A high profile municipality may default.	✓
The economy and corporate profits may surprise to the upside.	✗/✓
Rising protectionism may trigger a trade war.	✗
Emerging markets may stumble.	✓
Bond market volatility may increase.	✓

Won't

Statement	Result
P/E multiples will not exceed long-term averages.	✓
The housing market will not sustain a recovery.	✓
There will not be meaningful progress in deficit reduction.	✓
Commodity prices will not collapse.	✓
Inflation will not be a problem.	✓

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