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8065 Leesburg Pike, Ste. 300
Vienna, VA 22182
www.keelpoint.com

Expectations for the Year Ahead

The 2009-10 stock market rally fizzled last year. The MSCI All Country World Index, a market capitalization weighted benchmark for global equity markets, lost 7.4% in dollar terms in 2011. US domiciled stocks performed relatively better than their peers in the UK, Europe, Japan, and the emerging world. Returns in America were flat while all other regions lost value. There were plenty of reasons for the stagnation, but the top of the list would have to include rich world GDP at "stall speed," government debt calamity, volatile oil prices, the Japanese earthquake/tsunami, and China's efforts to temper growth. Some of these are temporary, some unresolved, so what does that mean for the coming year?

The biggest risk to stock market growth is the European sovereign debt crisis. The outcomes for the crisis in 2012 could be broken into three scenarios: 1) Europe rights the ship, 2) Europe finds enough Band-Aids to get through the year, or 3) the euro zone dissolves. Let's look at each in turn.

First, the most unlikely event – Europe rights the ship. The evidence for this outcome would include a significant decrease in the borrowing cost for the troubled European nations (for Italy that would likely mean <5% on 10 year debt, a level last observed in July before the crisis intensified). We would need to see the banking institutions meet their summer deadline to raise capital levels AND do so with meaningful amounts of new equity, not simply by cutting lending. Greece would need to default in an orderly fashion and the continent would need to be growing again at year end. Each requirement alone is daunting, together they are very unlikely. Should the heavens align though, we would see an extraordinary bump in stock prices.

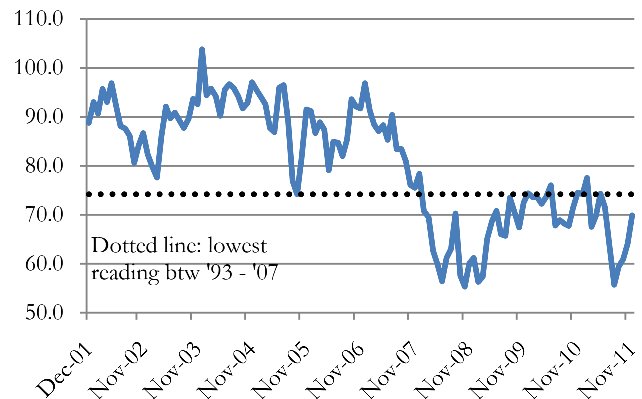
There is a much higher probability of the Band-Aids scenario. That is, after all, how we made it through 2011. The December European summit offered the latest effort to save the monetary union. The European Central Bank (ECB) will now lend funds to banks against a wide variety of collateral for up to three years. This is similar to what the Federal Reserve is doing in the US. The ECB's action has the effect of pushing money into the system in an attempt to drive down the cost of borrowing. This easing of monetary policy could blunt the impact of austerity (tax increases and government spending cuts) that the troubled countries (Greece, Ireland, Italy, Portugal, and Spain) are implementing right now.

The ECB's quick fixes help avert immediate meltdown, but they only serve to buy more time. With no permanent solution to the fundamental flaws in the monetary union and likely no growth, scenario two suggests little or no equity growth with volatile months throughout.

The last scenario – the euro zone's chaotic demise – is not likely. We get into some gory details in the next article, but suffice it to say this means serial defaults by governments and companies, a very deep recession, and probably civil uprising. Considering what Germany has at stake with the preservation of the monetary union, we think this will not be allowed to happen, at least not in a disorderly fashion. If it does, equity markets are in for a large correction.

The macroeconomic forces we have described (debt burdens, low/no growth, scarce credit) in many cases apply to the US as well. They suggest an unequivocally negative outlook for equities. However equity markets are less expensive as much of the depressing news has been accounted for in prices. Based on forward earnings, S&P 500 stocks are trading at about a 12x multiple, below average historically.

Figure 1: What Does 'Uncertainty' Look Like?
University of Michigan Consumer Sentiment



However, we see some pressure on both the price multiples and earnings. Investors are unenthusiastic about paying high multiples for earnings in the current uncertain environment. Consumers are uncertain (see Figure 1) for a host of reasons: a persistently weak labor market, underwater mortgages, etc. Business leaders continue to hold large amounts of undeployed cash. The government has not clearly defined the future tax and regulatory environment.

Earnings regained their pre-crisis peak in the second quarter and are estimated to increase 10% in 2012. US growth, however, is only expected to register 2%. Granted US corporations earn a large portion of profits overseas, but profit margins look unsustainably high. It wouldn't be a surprise to see earnings growth slow.

Our examination of the issues facing the equity markets leads to a few conclusions. We continue to favor emerging market equities. They face headwinds of their own, but are priced cheaper than last year. Second, we are planning for below trend equity growth with a wider than normal range of intra-year results on the way. We manage portfolios that hold equity positions alongside vehicles that may dampen the volatility: structured notes, long/short strategies, etc.

Fixed Income

US bond investors were aided by a strong rally in treasury bonds in the last half of 2011. A 10 year note purchased in the beginning of the year would have yielded 3.3%, whereas a similar note at year end would have only yielded 1.9%. The Fed's commitment to rock bottom rates through 2014 and the surge in demand during the fall stock market sell-off contributed to the decline in treasury yields. Despite what S&P thinks (see their 08/05/11 downgrade of the US credit rating), US bonds are still treated as the world's risk free asset.

However, fixed income is an exercise in relative value. We weren't attracted to the long-term payoff for a treasury bond investor when yields were just over 3.0% so it will come as no surprise that we are less attracted to sub-2.0% yields. It's hard to believe inflation will be less than 2.0% for the 10 year term of such a bond, therefore real returns are likely to be negative. Fed Chairman Bernanke desperately wants you to recognize this as a bad deal. He would rather you go out and spend your money, preferably on a house or two (a brand new one would be most ideal).

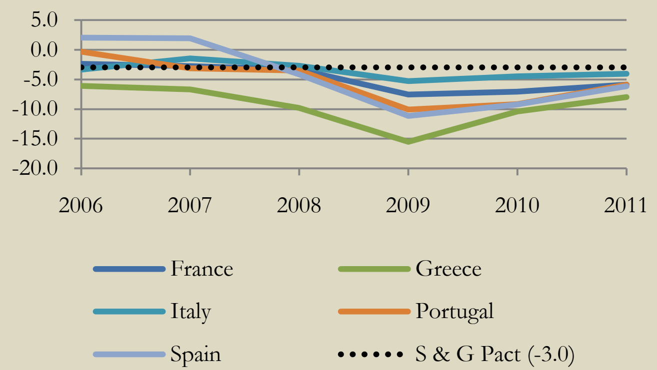
So what does offer value to a bond investor? Generally sectors that have a credit risk component in addition to interest rate risk. Corporate bonds look compelling, especially issuers in the high yield space. Non-investment grade borrowers are paying 7.0% over treasuries in a very low default rate environment (under 2.0%). Managers in the distressed space continue to uncover attractive risk/reward opportunities, and we are working on finding a manager to capitalize on what could be an enormous European distressed debt sale. □

What Happens if the Euro Breaks Up?

You may have read in the press that the euro zone is a modern version of the Hotel California. Individual member countries have the ability to set the direction of their fiscal policy, in recent years more recklessly than the 1997 Stability & Growth Pact allows ("You can check out any time you like", see Figure 2). But there is no mechanism in place for a country to exit the euro ("But you can never leave!"). There is little doubt Greece has 'checked out' and would seriously entertain figuring out how to leave.

What are the consequences of a divorce? Setting aside the unprecedented legal fights, the economic consequences would be devastating. The currency of Greece would revert to the drachma and immediately depreciate precipitously against the euro and other major currencies of the world. While this would help the country's exporters, inflation would take off as the price of imports jumped. All businesses that have outstanding debts in euros will be left with a devalued drachma to service those debts. Massive defaults would be likely. Furthermore, Greece would have to equalize revenues and spending because no one would lend to fund a deficit. Such a suddenly balanced budget inflicts more pain on an economy in critical condition. We've seen estimates that the cost to Greece could be as high as 50% of GDP.

Figure 2: Checking Out
Government Deficits (% of GDP)
Source: IMF, 2011 est.



In this scenario, contagion becomes a major problem. People have been taking deposits out of Greek banks already and any rumor that the country was on its way out of the euro would instigate a massive run on its financial institutions. This could be true of other troubled countries as well. The ability for European institutions to deal with such a flight of capital would be limited. Financial meltdown in Italy and Spain spells deep recession for the region.

Of course a Greece-led divorce is not the only break-up scenario. Some entertain the possibility of Germany losing patience with its profligate southern neighbors and joining with some of the stronger northern countries to form a currency union outside the euro. We do not see this as a real possibility as the German economy is heavily dependent on exports (40% of GDP) and that sector of the economy would be much less competitive against the depreciated southern currencies. As fed up as the Germans are, they know that they need a stable euro zone. □

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