January Ends on a High Note—But Will it Last?

With the first month of 2012 now behind us, there are a couple important points to note. Europe appears to be stabilizing—for now—and investors are beginning to recoup some of the confidence that was lost during the turbulent year that was 2011.

But is this confidence justified? Or is this a classic case of investors hearing what they want to hear and believing what they want to believe?

We'll start again with Europe, since the ongoing sovereign debt crisis is the single most important issue facing the world economy. Europe took several important steps in getting its fiscal house in order with its new fiscal treaty. At the end of January, every European Union country save the UK and the Czech Republic approved a German-sponsored treaty that would force Eurozone members to balance their budgets or face sanctions—essentially outlawing Keynesian economics.

The treaty should thrill fiscal conservatives and has done quite a bit to restore confidence in the bond market. This, along with fairly aggressive lending by the European Central Bank, has helped to avert what could have quickly turned into another 2008 meltdown scenario. This is the good news.

Now for the bad news. Europe is likely already in recession (we won't know for sure until GDP estimates are released). Cutting government spending to stay within treaty terms at a time when the private sector is shrinking and banks aren't lending will only make the recession worse. And the deeper the recession gets, the harder it will be for Europe's governments to raise tax revenues and service its existing debts. This is a vicious cycle, and we may just be in the early stages of it.

Meanwhile, both Greece and Portugal may still be heading for default, and no one knows what affect this will have on the world's stock and bond markets. Should things spiral out of control—which is still a very real possibility—we could indeed see a repeat of the volatility 2008. We'll know soon enough; Greece will likely default as early as late February or early March if no progress is made in its negotiations with creditors.

On the home front, the U.S. economic picture is also mixed. GDP grew by 2.8 percent in the fourth quarter of 2011, but 2.0 percent of this growth was due to inventory restocking of companies. Elsewhere, growth remains tepid at best.

The housing sector, which was the root of all of the turbulence of the past five years, also remains a mixed story. Nineteen of the twenty metropolitan areas tracked by the Case-Shiller Home Price Index fell in November, the last month for which we have data. This is the third consecutive month that the index has declined, falling 1.3 percent from October to November and 3.7 percent from November of the prior year. The enormous inventory of properties in foreclosure continues to act as brake to any recovery in prices.

Even so, we do see some welcome developments. Inventories of unsold homes continue to fall, and the price-to-rent ratio has fallen to its lowest level since the year 2000. In other words, homes are the most affordable they have been in 12 years versus renting.

All of this, in Europe, America, and beyond, can be summarized as uncertainty. We have a lot of uncertainty out there, and this requires vigilance on the part of investors and their advisors alike.

Hold on tight, dear investor. 2012 should be an interesting year.

Sincerely,

Jeremy E. Portnoff

Jeremy E. Portnoff, CFP®, AIF®, CRPS®, CES™, CFS®, CTS™, CAS®, CIS™
NAPFA Registered Advisor
Ed Slott Master Elite IRA Advisor
HS Dent Master Certified Advisor
Paladin Five-Star Advisor