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Global Asset Management

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There is no question that the odds of a possible recession in the United States and Europe have increased markedly over the last few weeks. Such an event would have global ramifications. Financial markets can be misleading at times and anticipate recessions that do not occur. But the flow of fundamental data and the action of stocks and, maybe more importantly, the action of bonds are giving signals that appear to be tipping the balance towards an eventual recession.

Our view has been that with housing in the dumps, auto sales at low levels, employment stable, all counterbalanced by continuing high growth in the developing world, the domestic economy would be characterized by very low growth overall; however, there would be sufficient progress by many business sectors to support markets. Global demand could be the engine that pulled the American economy ahead despite the overindebted consumer, overleveraged banking system and overspending government. This view is definitely at risk.

Many stocks are very cheap in any historic context, some ridiculously so in our view. But if indeed we are inevitably moving towards a recession in 2012, then the calculus on revenues, earnings and valuation levels could change significantly. Uncertainty takes its toll on price/earnings ratios. Remember how quickly the fundamentals changed back in 2008.

Not only would a recession undermine corporate earnings, but the ramifications for U.S. and European government finances would be profound as well. The U.S. budget deficit would widen significantly. The President, the Congress and the Federal Reserve would continue to attempt to stimulate the domestic economy, actions which would, in combination, more likely raise concerns about longer-term inflation, dollar weakness and Federal Government solvency.

Governments do not go easily into recession. Political pressures will intensify in 2012. Shortly President Obama will roll out his newest policies on jobs. Unfortunately, all parties and their policies are aimed to stimulate an overindebted consumer through an overindebted government. What is needed is a shift to longer-term encouragement of savings and investment through a comprehensive, supportive, multi-Federal Agency effort. Unfortunately, such policies are outside of the current political debate within the White House and Fed.

Once again we find ourselves as investors in a moment of potentially great change. This will not unfold in a single month. While we can see more pressure on the markets, we can equally see over the next few months responses that try to elevate prices and conceivably keep the economy moving. This letter is meant to lay out the reasons for change and to introduce the further possibility of more profound risks in 2012.

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