Financial Outlook for 2012

Robert S. Neal: Associate Professor of Finance, Kelley School of Business, Indiana University Bloomington
Charles Trzcinka: Professor of Finance, Kelley School of Business, Indiana University Bloomington

Since last summer, the financial markets have been on a European roller coaster ride. We could call it the "Beast" but at least we know that ride ends safely. This ride depends on whether the Europeans can figure out how to keep funding the debt of nations that have promised more than they can afford. When the situation looks as if it will be resolved, the markets climb higher. When the agreements collapse, the markets plunge with frightening speed.

Sooner or later, the situation will stabilize and then fundamentals like earnings, leverage and risk will return to the market. At that point we can get off the ride. When we exit, we expect that the financial markets and the U.S. economy will move closer together with the markets showing positive but below average growth.

In the 12 months ending November 2011, the S&P 500 rose about 3 percent. While the return was positive, it was dramatically lower than for the same period last year. The markets peaked in April, but the drumbeat from Europe and the tepid performance of the U.S. economy has erased most of those gains. Short-term interest rates have remained close to zero throughout 2011, and the long-term bond rates are very close to historical lows. As expected, the Federal Open Market Committee (FOMC) decided to continue with the current program of asset sales and purchases ("Operation Twist"). This strategy is designed to lower long-term rates and promote investments in housing and business equipment. The FOMC reiterated its expectation that current economic conditions "are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."[1]

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Economic Fundamentals

Stock prices are a very good indicator of future economic activity: investors buy stocks anticipating the real economy will pick up in the near future. There are many positive reasons to believe this story now:

- Corporate earnings have been remarkably resilient. Earnings for S&P 500 companies rose about 11 percent in 2011 and are expected to rise 9 percent in 2012.
- Price/Earnings (PE) ratios are close to historic averages. Shiller's long-term PE ratio is above average, but the current and forward PEs are below average values.
- Major banks, although still weak, have weathered the storm and are slowly rebuilding their balance sheets.
- The Federal Reserve is continuing to keep interest rates low to fuel the economy. The Fed Funds target rate of 0 percent to 0.25 percent will probably be maintained throughout 2012, and the 10-year bond rate will likely maintain its current rate of 2 percent.
- The weak dollar will help companies grow their exports. The euro has fluctuated around $1.37 in spite of the problems with European debt.
- The value of U.S. commercial real estate rose in August compared to the previous month. *Bloomberg BusinessWeek* reported that the Moody's/REAL Commercial Property Price Index shows commercial property prices in the nation climbed by 2.4 percent on a monthly basis. This also represented a hike of 7.2 percent over the same month in 2010.

However, there are negative issues that could make the market recovery short-lived:

- The euro zone political economy.
- The decline in residential housing prices appears to be continuing in most parts of the country. The national Case-Shiller Index has fallen about 3 percent from September 2010 until August 2011. Of the 20 metro areas in the index, year-to-year price declines occurred in 17 of the 20 markets.
- The Conference Board Leading Economic Index (LEI) for the U.S. increased 0.2 percent in September to 116.4 (2004 = 100), following a 0.3 percent increase in August and a 0.6 percent increase in July. September data show moderating growth in the LEI, according to Ataman Ozyildirim, economist at The Conference Board. "The weaknesses among the leading indicator components have become slightly more widespread in September. The slow pace in the LEI suggests a growing chance that this sluggish economy is going to be here for a while."[2]

- Inflationary pressures have started to increase. The overall CPI rose 3.9 percent from its level a year ago. Commodity prices have been rising much faster. The PPI Commodity Price Index has increased 10.3 percent from year-ago levels. Eventually this will be reflected in higher production and transportation costs.
- In spite of the recent upturn, industrial output is still only 77 percent of capacity, well below the long-run average (including previous recessions) of 81 percent.
- The massive government deficits may lead to fears of higher interest rates and accelerating inflation. Both will have an adverse effect on business investment. The budget deficits for 2009, 2010 and 2011 totaled 30 percent of U.S. GDP. The federal government will need to borrow about $4.5 trillion to finance this spending. The projected budget for 2012 is somewhat lower, about 7 percent of GDP. If the 2012 deficit is financed by tax increases, the tax bill will average about $3,500 per person.
- The U.S. still faces a huge funding deficit in Social Security and Medicare payments. The present value shortfall is about $62 trillion. This is equivalent to $206,000 per person or $825,000 per U.S. household. These problems are not insurmountable, but they do require common sense and bipartisan leadership—something that appears to be in short supply in Washington, D.C.

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Forecast

Looking forward to 2012, the positives outweigh the negatives for the economy. We expect the recovery to continue, albeit at a rate much slower than a typical recovery with GDP growth in the 1 to 3 percent range and inflation in the 2 to 4 percent range. The pace of the recovery, however, will not improve until consumers have increased their savings and repaired their balance sheets. This process will extend beyond the end of 2012.

In this environment, we project the return to equities to be positive, but below the long-run average return of 9 percent. With Treasury bonds already at extremely low yields, there is little potential for gains with these investments. In addition, we think there are material long-term inflation risks which could make long-term bonds unattractive. In contrast, the low Treasury rates make mortgage rates extremely attractive, with 30-year fixed rates at 3.875 percent and 15-year fixed rates at 3.25 percent. Homeowners who are paying 5 percent or more on their mortgage and expect to stay in their home for several years would likely benefit from refinancing their mortgage.

Summary

The U.S. economy appears to be heading to smoother waters but unemployment remains a stubborn reminder of the recession. Partisan politics may continue to disrupt economic relationships. The adjustment process to full recovery and full employment, however, will likely take at least two years. Until a complete recovery is in sight, we expect market returns to be positive, but below their long-run average.

Notes

1. "Press Release," Board of Governors of the Federal Reserve System, August 9, 2011, www.federalreserve.gov/newsevents/press/monetary/20110809a.htm.
2. "News Release: The Conference Board Leading Economic Index (LEI) for the U.S. Increases Slightly," The Conference Board, www.conference-board.org/pdf_free/press/PressPDF_4316_1319097258.pdf.