



# Global Market Commentary

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## Lessons Learned in 2011



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### Executive Summary

As the year comes to an end, I review the factors that influenced the equity markets this year and what investment themes worked or didn't work, and begin to formulate my outlook for 2012 (which will be published in January).

- **Lesson one: Crisis delayed but not averted.** Europe's solvency/liquidity problem dragged many world equity markets into bear territory this year and has given rise to a banking system crisis as well. Investor sentiment was lifted by the recent coordinated effort of six central banks around the world to try to bolster confidence for European banks. But the market rally is likely to be temporary, and fundamental issues remain for the region. More decisive action by European leadership is needed to keep the European crisis from becoming a truly global crisis.
- **Lesson two: Political infighting has become an economic liability.** The last-minute increase to the U.S. debt ceiling, the failure of the Congressional "super committee" to agree on necessary budget cuts and the series of inadequate solutions trotted out by European policymakers have undermined confidence in policy and do not bode well for future economic growth.
- **Lesson three: The U.S. economy has improved but remains fragile.** Despite recent positive surprises in third-quarter gross domestic product (GDP) and the unemployment rate, the risk of recession in the U.S. has not totally disappeared.
- **What does it mean for 2012?** Contagion risk from Europe cannot be underestimated, and I believe investors will continue to contend with volatility arising from that front. But whether U.S. economic growth can help buffer a global economic slowdown or whether the rest of the world will drag the U.S. economy down are scenarios I plan to explore in the full 2012 outlook due to be published in January.

The following pages will expand on these insights and examine the implications for equity investors.

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**Given the historical 0.86 correlation in GDP between our two regions, the problems in Europe will have an impact here.**

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## **Lesson one: Crisis delayed but not averted**

In 2011, global equity markets were whipsawed by Europe's ever more complicated sovereign debt woes and policymakers' ultimately disappointing attempts toward a solution. Many of the world's equity markets fell into bear market territory during the year. Europe (as measured by the MSCI Europe Index) was down as much as 32%, and Japan (as measured by the Nikkei Index) declined 25% from peak to trough.<sup>1</sup> Despite the superior GDP growth rates in the emerging markets, the MSCI Emerging Markets Index was down 31% from peak to trough this year.<sup>2</sup> Only the S&P 500 Index stayed above the bear market threshold (commonly defined as a decline of 20%) with a peak to trough decline of 19%.<sup>3</sup> It has become apparent that European authorities are dealing with a toxic mixture of a banking system crisis and a sovereign debt crisis. As such, distressed countries do not have the balance sheets to bail out their banks, and the cost of funding is high.

Recently six central banks from around the world took action by cutting their overnight borrowing rates for U.S. dollars in the swap market so European banks would have access to overnight funding. This was not a political commitment to move to fiscal union in exchange for the European Central Bank (ECB) becoming the lender of last resort. It was the recognition by central banks that a major funding problem was about to unfold and the European Financial Stability Fund (EFSF) was incapable of preventing it. Central banks have opened or extended swap lines a number of times since 2007. Almost invariably the equity markets rejoiced in the short term but eventually declined to new lows.<sup>4</sup>

So, the saga continues with more "Band-Aid" solutions for a region that is hemorrhaging in debt and is expected to move into recessionary territory in the fourth quarter. Although the measures taken so far have bought the European authorities more time, there is much more work to be done to resolve the region's fundamental issues of solvency and administer fiscal responsibility without crippling long-term economic growth.

I believe that in 2012, investors will continue to deal with heightened volatility from time to time as the solvency risk in Europe flares up. Given the historical 0.86 correlation in GDP between our two regions, the problems in Europe will have an impact here.<sup>5</sup> U.S. investors cannot totally discount the risk of recession despite the recent economic upward momentum.

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## **Lesson two: Political infighting has become an economic liability**

Granted, this is not a new idea, but political risk hasn't been felt so acutely in the U.S. and Europe for some time.

In the U.S., the last-minute increase to the nation's debt ceiling in August and the failure of the Congressional "super committee" to agree upon the deficit-reduction plan added an element of political uncertainty to the markets, at a time of economic uncertainty. The upcoming election year is likely to ensure more of the same, in my view, with politics trumping progress toward fiscal responsibility.

The European political environment has been similarly disappointing. Delaying the risk of a sovereign debt default or the bankruptcy of a major European bank doesn't remove the risk. Until the ECB becomes the lender of last resort, the risk of another funding crisis remains, in my opinion. It will be difficult for the peripheral countries to reverse their recessionary path until the ECB embraces an aggressive monetary policy through quantitative easing, thereby weakening the currency. Both of these solutions rest on the decisions by politicians in Germany, for the most part. Germany is the only EU member with the balance sheet to finance the ECB.

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I believe spikes in volatility that plagued the equity markets this year will continue in 2012 as more potential solutions are announced and ultimately disappoint. Regardless of when a comprehensive solution is found, the result will likely mean years of below-trend growth as austerity measures are implemented and banks and governments deleverage their balance sheets.

### Lesson three: The U.S. economy has improved but remains fragile

Recession probabilities were increasing for a good part of 2011, but there have been some surprises recently. Third-quarter GDP was higher than expected, and the unemployment rate fell below 9%. However, the increase in third-quarter GDP (which will likely continue in the fourth quarter) can be attributed to nothing more than GDP growth returning to the growth rate established in the second half of 2010, in my opinion, aided by a \$0.70 per gallon decline in gasoline prices that provided consumers with additional disposable income.<sup>6</sup> Another contributor to the rise in third-quarter GDP was an increase in consumer spending resulting from a decline in the consumers' savings rate from 5.3% to 3.6%.<sup>7</sup>

For the U.S. economy to continue to improve, wages and/or employment are obviously going to have to improve. However, the recent decline in the unemployment rate from 9.0% to 8.6% had more to do with fewer people looking for jobs than people getting jobs.<sup>8</sup> Unfortunately, most of the recent job gains have been for temporary workers and retailing.<sup>9</sup>

The austerity measures and deleveraging process in the euro area will have a negative impact on U.S. economic growth, as will impending U.S. fiscal restraint. Consequently, the threat of recession still exists. Recent economic data would say otherwise, but the factors underlying the improvement appear temporary, in my view. That said, seasonal effects are likely to move the equity market higher until the fundamentals say otherwise.

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#### What has been working in 2011

Year-to-date index returns as of Nov. 30, 2011<sup>10</sup>

Percentage

##### U.S. outperformed developed and emerging markets

S&P 500 Index	+1.08
MSCI World Index	-5.55
MSCI World Index ex-US	-11.80
MSCI EAFE Index	-12.22
MSCI Emerging Markets Index	-12.46

##### U.S. large caps outperformed small caps

Russell 1000 Index	-1.17
Russell 2000 Index	-5.90

##### Among U.S. large caps, growth outperformed value

S&P 500/Citigroup Growth Index	+4.31
S&P 500/Citigroup Value Index	-2.27

##### High quality outperformed low quality

A+ rated (BofA/Merrill Lynch U.S. universe)	+8.01
C and D rated (BofA/Merrill Lynch U.S. universe)	-25.77

##### High-dividend-paying stocks outperformed low-dividend-paying stocks

Highest yielding S&P 500 stocks	+8.68
Lowest yielding S&P 500 stocks	-14.19

Past performance is no guarantee of future results. An investment cannot be made in an index. Source: Bank of America (BofA)/Merrill Lynch, via Reuters Knowledge, U.S. Quantitative Strategy (unless otherwise indicated). Source for MSCI World Index, MSCI World Index ex-U.S., MSCI EAFE Index and MSCI Emerging Markets Index: BofA/Merrill Lynch, via Reuters Knowledge, U.S. Quantitative Strategy and MSCI. Source for dividend-paying stocks: BofA/Merrill Lynch, via Reuters Knowledge, U.S. Quantitative Strategy and I/B/E/S. All data as of Nov. 30, 2011.

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## 2012 preliminary outlook

### United States

**Headwinds:** Anemic job growth, political brinksmanship that creates a policy drag, global economic slowdown, possibly a strong dollar (which would negatively affect corporate earnings), and European funding crisis.

**Tailwinds:** Fourth year of presidential cycle, housing and the financial sector close to bottoming, investor sentiment too pessimistic, potential Chinese fiscal stimulus package, and possibly a European debt solution announced.

**Preliminary conclusions:** Overweight. First-quarter market bottom sets the stage for higher levels as the European sovereign debt crisis diminishes, and a coordinated global stimulus, especially from China, reflate growth and the demand for U.S. goods.

### Europe

**Headwinds:** Recession, credit crunch as banks shed assets, deleveraging and austerity that keeps the region in a multi-year cycle of economic contraction and low growth, and continued downward earnings revisions.

**Tailwinds:** Recession and earnings risk already priced, quantitative easing positive for equities, economic data that continues to surprise on the upside.

**Preliminary conclusions:** Underweight. Tight fiscal policy and not-so-accommodative monetary policy does not bode well for stocks. Other than a relief rally from announced policy changes that temporarily reduces bank funding pressures, equities trade in a see-saw pattern, but the trend is to the downside.

### Emerging markets

**Headwinds:** Global slowdown, lags in monetary policy tightening still negatively affecting growth, and possibly a strong U.S. dollar.

**Tailwinds:** Declining inflation, fiscal and monetary stimulus, and low valuations.

**Preliminary conclusions:** Underweight for now. The ongoing debt crisis in Europe and global economic slowdown are likely to contribute to continued weakness for the asset class in the short term. But positive economic growth and improved market performance could follow in the second half of the year.

**As the New Year approaches, it would seem easier to forecast the probable outlook for the U.S. equity markets if we didn't have to factor in the events overseas.**

As the New Year approaches, it would seem easier to forecast the probable outlook for the U.S. equity markets if we didn't have to factor in the events overseas. After all, conditions are in place for the seasonal influences to move the equity market higher given the decline in inflationary pressures, short- and long-term interest rates near zero, favorable credit conditions, a healthier banking system, housing inventories approaching levels for price stability and fourth-quarter GDP tracking at 3%. In addition, earnings are expected to improve next year, equity valuations are below average and the risk premium remains elevated.

However, contagion risk from the European sovereign debt crisis remains and should not be underestimated. The emerging markets, the world's growth engine, are slowing and very much affected by the events in Europe. The deleveraging of debt in the European banking system will likely tighten financial conditions in Latin American and Eastern Europe. A European recession will negatively affect export growth in Asia. Will U.S. GDP growth help buffer the global economic slowdown or will declining global growth end the recent growth spurt in the U.S.? That will be the main question I will address next month in the 2012 Global Investment Outlook.

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**Important information**

The opinions referenced above are those of Richard Golod as of the date of this report and are subject to change at any time due to changes in market or economic conditions and may not necessarily come to pass. These comments are not necessarily representative of the opinions and views of other Invesco investment professionals. The comments should not be construed as recommendations, but as an illustration of broader themes. Past performance is no guarantee of future results.

All investing involves risk including the risk of loss. Diversification does not eliminate this risk. Investments in foreign markets entail special risks such as currency, political, economic and market risks. The risks of investing in emerging-market countries are greater than the risks generally associated with foreign investments. Small- and mid-cap stocks carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies.

Common stocks do not assure dividend payments. Dividends are paid only when declared by an issuer's board of directors and the amount of any dividend may vary over time based on the business prospects of the company.

This material is for educational purposes only and does not contend to address the financial objectives, situation or specific needs of any individual investor. It is not a solicitation, or an offer to buy or sell any security or investment product.

- 1 Source: Bloomberg, L.P., Nov. 30, 2011. The MSCI Europe Index peak to trough is measured from Feb. 18, 2011 (high) to Sept. 22, 2011 (low). The Nikkei Index peak to trough is measured from Feb. 21, 2011 (high) to Nov. 25, 2011 (low). The MSCI Europe Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe. The MSCI Europe Index consists of the following 16 developed market country indices: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom (as of May 30, 2011). The Nikkei 225 Index (or Nikkei Index) is a price-weighted index measuring the top 225 blue-chip companies on the Tokyo Stock Exchange and is commonly considered representative of Japan's stock market.
- 2 Source: Bloomberg, L.P., Nov. 30, 2011. The MSCI Emerging Markets Index peak to trough is measured from May 2, 2011 (high) to Oct. 4, 2011 (low). The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey (as of May 30, 2011).
- 3 Source: Bloomberg, L.P., Nov. 30, 2011. The S&P 500 Index peak to trough is measured from April 29, 2011 (high) to Oct. 3, 2011 (low).
- 4 Source: BCA Research Inc., Dec. 5, 2011
- 5 Source: Gluskin Sheff, Nov. 18, 2011. Correlation indicates the degree to which two investments have historically moved in the same direction and magnitude.
- 6 Source: Bloomberg, L.P., Nov. 30, 2011. Gas prices are the average gas prices as measured by the travel group AAA.
- 7 Source: Gluskin Sheff, Oct. 31, 2011
- 8 Source: "U.S. Jobless Rate Unexpectedly Drops to 8.6%, Payrolls Rise," Bloomberg News, Dec. 2, 2011
- 9 Source: "U.S. Jobless Rate Unexpectedly Drops to 8.6%, Payrolls Rise," Bloomberg News, Dec. 2, 2011
- 10 The **MSCI World Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World Index consists of the following 24 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States (as of May 31, 2011). The **MSCI World Index ex-U.S.** is the MSCI World Index excluding the United States. The **MSCI EAFE Index** (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The **MSCI EAFE Index** consists of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom (as of May 30, 2011). The **Russell 1000 Index** measures the performance of the large-cap segment of the U.S. equity universe. The Russell 1000 represents approximately 92% of the U.S. market. The **Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. The **S&P 500 Growth and Value Indices** measure Growth and Value in separate dimensions across six risk factors. Growth factors include sales growth, earnings change to price and momentum; and the Value factors include book value to price ratio, sales to price ratio and dividend yield. The regular Style Index Series includes all stocks from the parent index into growth and value components, and weights them by market capitalization. High and low quality stocks are those rated within the Bank of America/Merrill Lynch U.S. Universe of 1,600 stocks. Standard & Poor's has provided Earnings and Dividend Rankings, commonly referred to as Quality Rankings, on U.S. common stocks since 1956. Quality Rankings reflect the long-term growth and stability of a company's earnings and dividends. Rankings are measured on a scale that generally ranges from A+ (highest) to D (lowest); rankings are subject to change without notice. For more information on Standard & Poor's ranking methodology, please visit S&P's equity research page at [www.standardandpoors.com/products-services/equity-research-main/en/us/](http://www.standardandpoors.com/products-services/equity-research-main/en/us/). The highest-yielding S&P 500 stocks are those with yields ranging from 3.21% to 13.11%; the lowest-yielding are 0.07% to 1.03%, as determined by BofA/Merrill Lynch U.S. Quantitative Strategy.

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The S&P 500® Index is an unmanaged index considered representative of the U.S. stock market. An investment cannot be made in an index.