ASPIRIANT

Insight

Wealth Management Commentary

Achieve more.

February 2012

Dear clients and friends:

After nearly 20 years of publishing Insight as a quarterly newsletter, we're transitioning to a publication schedule that's more frequent (initially, monthly) and features only one or two articles per edition. This change in approach is consistent with the evolution of communications generally and, we hope, will provide you with more timely and digestible information.

If there are specific investment and wealth planning topics that you would like us to write about, please share your ideas with us.

Sincerely,

Rob Francais
Chief Executive Officer

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2012 Outlook: What Will Drive Investment Returns This Year?

2011 was a year of change … and we expect investors to focus on a narrower range of issues in 2012.

So many big things happened to affect the global economy and capital markets during 2011 that it's hard to remember them all:

- Japanese earthquake and tsunami;
- Sweeping political change in Tunisia, Egypt and Libya, and ongoing civil unrest elsewhere in the Middle East;
- US credit rating downgraded for the first time in history; and the
- Intensification of the European debt crisis, to name a few.

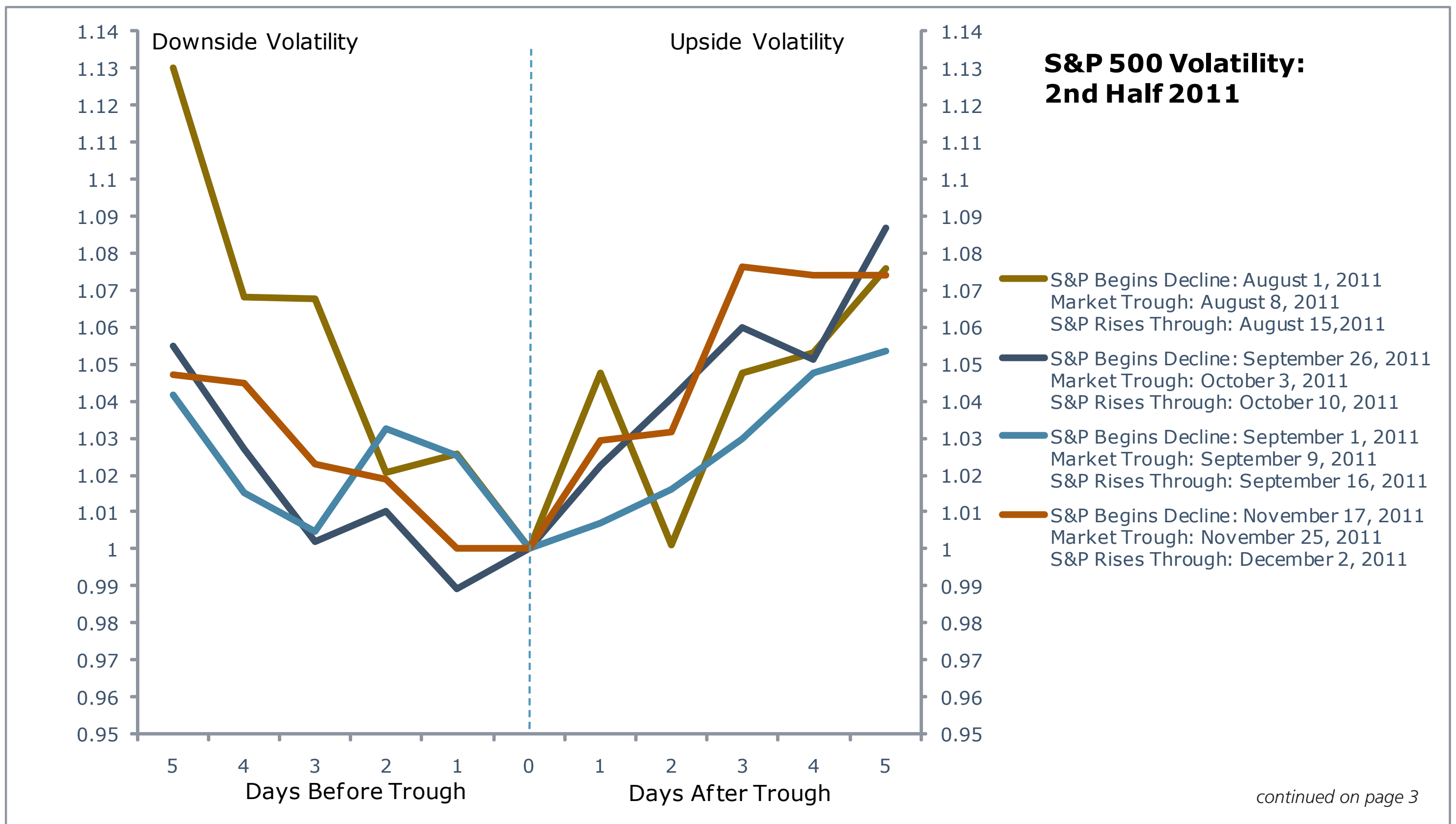
The result was repeated market reversals, with an unusual number of successive equity market drawdowns. In many cases, markets rebounded sharply, regaining a significant portion of the drawdown within just a few days. In an environment driven by macro-economic (rather than company-specific) concerns, some of our investment strategies (like tilting public equity portfolios toward "value" companies) underperformed, especially in the third quarter.

Looking forward, we expect the primary stories over the next year to be European economic weakness and U.S. economic resilience.

Europe will remain on investors' minds …

The biggest risk globally remains the crisis in Europe. The consensus of professional economists is that Europe will suffer a recession early this year, with stabilization in the second half of the year if the European sovereign debt situation results in a sustainable solution. This deal will likely take the form of Germany agreeing to support European debt (through Eurobonds, more extensive use of the European Central Bank's balance sheet, extension of the Eurozone's sovereign rescue fund, or even a controlled default followed by publicly-funded bank recapitalization) in return for greater influence over future deficits.

It is easy to envision more difficult scenarios, owing to unwillingness in Germany to bear the cost, unwillingness elsewhere to submit to budgetary controls (including in France, which is gearing up for an election), or the departure of a peripheral country from the Euro area that triggers broader turmoil. In addition, the feedback effects between the economy and fiscal policy look as discouraging as ever.



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The upward revision of the Spanish deficit for fiscal 2011 to 8% of GDP coupled with an announcement of additional expenditure cuts and tax hikes is a case in point. Cutting expenditures too rapidly becomes self-defeating via the induced weakness in the economy. Similar disappointments elsewhere are possible.

… even as the Federal Reserve is working to support the U.S. economy …

The European crisis has not yet had much impact on US growth, but there's no question that it has left its mark on Fed officials who continue to see "significant downside risks" to the outlook. On January 25 the Federal Open Market Committee (FOMC) formally defined its inflation objective for the first time: a 2% annual rate of increase in the price index for personal consumption expenditures (PCE). Also for the first time, the FOMC released committee participants' projections for the "appropriate" federal funds rate over the next few years and in the longer term. Finally, the policy statement included a major easing step: the guidance that "economic conditions…are likely to warrant exceptionally low levels for the federal funds rate" was extended from "at least through mid-2013" to "at least through late 2014". The message is that the FOMC acknowledges the relative weakness of the recovery and is committed to aggressively using monetary policy to stimulate growth.

These announcements come against the backdrop of an economy that is continuing to recover from the financial crisis and deep recession and is heading into its own election year. There are many signs that the economy has turned the corner… consumer and business confidence is increasing, corporate profits continue to be strong, employment is steadily improving, and housing appears to have finally bottomed out in many areas. As we saw in 2010, though, these gains could prove fleeting if the economy encounters unexpected shocks.

… and they are not alone.

The last couple of years have seen a gradual normalization of interest rate policy across the world following the tremendous interest rate reductions in response to the financial crisis of 2008/09. Outside of the US, UK and Japan, interest rates have risen in most emerging and developed economies, reflecting their still robust growth. This tightening in monetary policy came alongside a tightening in fiscal policy as governments across the world moved to improve government balance sheets and reduce deficits.

As we look ahead to the rest of 2012 and beyond, this fiscal tightening is set to continue, and even increase in many advanced economies. But with respect to monetary policy, the year ahead is likely to be dominated by easing policy around the world. This is an important shift as it offsets to some extent restrictive fiscal policy. While we think monetary policy easing will occur around the world, the nature and pace of easing is likely to differ significantly. We expect several important emerging markets to shift from the tightening stance they held through much of last year to an easing stance in 2012, joining the few (such as Brazil and China) that have already eased. And for the major economies that are at the zero bound for policy rates (the US, Euro-zone, UK and Switzerland), we expect further unconventional easing measures in the coming few months.

We continue to look for opportunity.

Professional investors are rarely in a position to buck the trend and be proven right in short order. For Aspiriant, that happened last year as we made our case for higher-yielding municipal bonds (see our January 2011 Investment Perspectives "Municipal Bonds: An Unusual Investment Opportunity") in an atmosphere of great concern over municipal finance. After municipal bonds failed to respond to the Federal Reserve's commitment last year to keep rates low through 2013, we increased client allocations to longer duration and higher yielding municipals, which have subsequently responded well to the brightening economic outlook. Investors willing to bear the discomfort of investing contrary to the herd mentality are often handsomely rewarded.

Some substantial and legitimate global concerns continue to create a lot of uncertainty, which weighs heavily on markets. We ultimately expect, though, that the European debt situation will ease (albeit not as soon or as smoothly as anyone would like) and that growth in the US and developing nations will solidify, all of which bode well for investment markets over the coming couple of years.

Jason Thomas, Ph.D., CFA
Chief Investment Officer

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