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CAPITOL MARKET REVIEW

Meet the New-Year, Same as the Old-Year

At Mid-Day: SPX 1281 US10Y 1.95% Gold $1600 Oil $102 January 3, 2012

A sea of green greeted US investors as Asia and Europe both rallied into today's first trading day of 2012.

The SP500 is currently up 2% on no particular news. However, stocks are not alone in their rally. Gold is also up 2% and Oil is up nearly 4% above $100. (Although, absent Iranian saber rattling, Oil would probably also be up about 2%.)

What's changed as the calendar rolls from 2011 into 2012? Not much. 2011 was remarkable for its volatility -- dramatic selloffs, remarkable recoveries, anomalies between asset classes that defied historic comparisons. Capitol Markets Report expects a repeat of the same volatility this year.

There have been no major announcements out of Europe where budget deficits, credit ratings agency downgrades, looming sovereign debt implosions and more than likely a recession are all predicted within the first six months of 2012. In spite of economic, political and perhaps social dislocations of historic proportion, the relationship between the much maligned Euro and other key global currencies remains within trading bands. In dollar terms, the Euro is trading at $1.30. A cheaper Euro continues to buoy Germany, where unemployment is dropping as a relatively inexpensive Euro has led to increased demand for many well known German exports.

Asia continues to grapple with the key linchpin for their economic model. Emerging Asian economies, led by China, are building their middle class by aggressively exporting "cheap" goods to developed nations, while juggling the implications of balance of trade and currency valuations. As many investment historians have noted, even with the best central planners in the world, it is impossible to operate an economy of China's size with an immature capital structure. In spite of appearances, inflation and credit bubbles throughout Asia cannot be avoided. Therefore, talk that China can engineer a soft landing without consequence is naïve.

2012 is an election year in the US and CMR expects the Obama Administration will do everything in its power to re-elect The President. The best way to achieve a second term for The President is to create a statistical recovery in US housing and employment. In spite of the oft noted political rancor between Democrats and Republicans, Congressmen and Senators also share an affinity for re-election. CMR expects that the federal system will attempt to both generate more rhetoric, but seek some form of compromise as successfully kicking the can probably means re-electing incumbents.

CMR predicts the following…Europe will experience a recession. The European Union will remain the dominant negative theme for 2012. The US will continue to grow, but at no more than 2%. Emerging Asian economies will experience inflation and slower growth. The US Fed will conduct another round of quantitative easing, purchasing both US Treasuries and US MBS. The end of the world will occur on the Winter solstice. After another volatile year, equities will be only marginally higher. Bond yields will remain locked. Currencies will trade in artificial patterns due to central bank intervention. Commodities will again be highly volatile reacting to central bank intervention, but ultimately to slower global growth. Developed nations will continue to grapple with unsustainable entitlement programs as demographics and tax policies based on backward looking assumptions continue to force cuts and unwanted increases.