

Economic Outlook 2012

A Long-Range Economic Look at the year 2012



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Economy

POSITIVES

- The Federal Reserve's policies are accommodative
- Interest rates are low
- Exports thrive for now
- Untapped energy reserves in the U.S.

NEGATIVES

- Political uncertainty in Washington
- New government programs and overspending are unpopular among voters
- Problems in Europe and a stronger dollar will slow exports
- Excessive unemployment inhibits spending

It takes considerable time for countries to rebound from major financial crises. Thus, excessively high unemployment will continue to hamper a speedy resolution of our economic problems. Corporations are not hiring because of new federal programs and regulations. Furthermore, the dangers of overspending have not been adequately addressed at the federal level. This is sowing the seeds of inflation.

As we previously projected, the U.S. has bounced along at low levels of economic activity, with feeble GDP increases. The business community has received little encouragement from Washington. Still, Americans are resourceful and we see a country that is stabilizing and slowly improving. Except for the situation in Europe, we would be very hopeful about the future. About 20% of our exports go to Europe and many U.S. firms have a major presence there. Bond investors forced many European yields to unsustainable levels as high debt levels and confidence in repayment lagged. The potential recession in Europe will also threaten the U. S. economy.

Stocks

POSITIVES

- Deficit spending a temporary help
- Phenomenal corporate earnings

NEGATIVES

- Stock valuations are high
- Corporate insiders are selling
- Voters disapprove of current policies
- Strong U.S. dollar usually hurts earnings and exports
- Profit margins at risk

Several useful valuation methods such as dividend yield and price / average long term earnings suggest the next 10 years' returns will be lackluster. This favors active management and bargain stocks as opposed to an index or a buy-and-hold strategy. Volatility will remain high and with it periods of risk and opportunity.

Election years are usually good for stock investors. However, this is most often the case when voters are optimistic. Currently, we find an extreme level of voter disapproval. In the past, the public's displeasure is often reflected in substandard returns.

A strong dollar may create difficulties as well. Historically, a rising dollar often reduces export sales which many corporations rely on for growth. Additionally, our research shows that corporations may not be able to pass along all of their cost increases. This could hurt profit margins.

We do find opportunities, especially in bargain stocks. In addition, companies that reward their shareholders with solid dividends and buy back their own shares tend to perform better in periods of high volatility. Similarly, companies with a greater focus on domestic sales and imports may be able to take advantage of a stronger dollar. Likely winners in this environment include importers such as discount retailers.

Bonds

POSITIVES

- The Federal Reserve insists on low interest rates
- Gridlock in Washington slows spending growth
- Bonds usually do well in Presidential election years
- U.S. treasuries are a safe haven
- Weak U.S. economy

NEGATIVES

- Strong returns of 2011 hard to replicate
- Inflation erodes real returns
- Low yields push investors into riskier assets
- Our long term bond indicators are less favorable
- Great bond bull market coming to a close

Investors who held bonds in their portfolios prospered in 2011, especially those who held the highest quality and longer term bonds. The debt ceiling issue initially caused a panic. However, the panic created opportunities and in its aftermath, long term U.S. treasury bonds rallied over 20%!

The Federal Reserve pulled out all the stops while trying to keep rates low. They have gone through two rounds of Quantitative Easing to keep short term interest rates low. They are now trying to depress long term rates with their newest program, 'Operation Twist'. This allows the Fed to purchase \$400 Billion of long term U.S. treasury bonds.

Long term U.S. treasury bonds were among the best investments over much of 2011. It would be unusual for them to do as well in 2012. Our research shows that high returns for bonds are typically followed with subpar returns. As long as problems in Europe persist, higher quality issues will remain attractive. The same will be true in periods of weakness here in the United States. However, opportunities are rising for TIPS, municipal bonds and corporate bonds. We will consider gradually shifting to these, especially when we believe the economy is about to rebound. Active management of sectors and maturities will be needed in a volatile market.

International

POSITIVES

- Many foreign markets are cheap
- Some progress is being made in Europe
- Emerging Asia is still strong
- Japan's rebuilding will support global economic growth

NEGATIVES

- Europe's debt problems are serious
- Inflation worries will mount in 2012
- Populist pressures resist reform in Europe

Europe will remain center stage in 2012. Newly elected leaders in Portugal, Italy, Ireland, Greece and Spain will grapple with unsustainable budget deficits and weakening economies. Furthermore, labor unions and populist forces will resist reform. A broad recession is likely in Europe following needed revisions to the European Union charter. There is a rising probability of a Greek default on its foreign held debt.

GDP growth will remain positive in emerging Asia and Latin America as growing domestic demand helps offset a slowdown in exports. However, inflation concerns are starting to rise. After the earthquake and tsunami in Japan, rebuilding there will help offset some of the global weakness. Still, developments in Europe will be critical.

We like countries with low public debt and low current account deficits. Some of these are Norway, Sweden, Poland and Mexico. We also think countries with lower misery indexes (inflation plus unemployment) and good valuations are more attractive. Some of these are Norway, Taiwan, Chile and Indonesia. The international investing situation remains fluid and an active approach should be helpful.

For Business Executives

Expect:

- Economy will remain stagnant
- Unemployment to be stubbornly high
- Dollar remains King and will strengthen
- Consumers are spending their savings
- Energy boom coming to U.S.

Advice:

- Upgrade your staff and capacity
- Don't over hire
- Diversify if export dependent
- Expand domestic sales
- Take advantage of lower import prices
- Find opportunities in future domestic energy boom

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For Investors

Stocks:

- Lower expectations for international and U.S. markets
- No bull market on the horizon
- High volatility rewards active not passive management
- Favor importers and high domestic sales
- Look for bargain stocks with strong dividends and stock buybacks

Bonds:

- No repeat of 2011's great gains
- Expect volatility
- Great bond bull market coming to an end
- Avoid buy-and-hold for long term bonds
- Active management required to succeed
- Eventual leadership may change to TIPS, Munis, and Corporates

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