Financial Forecast 2012

Waves of Uncertainty

Smart Moves for Another Challenging Year

By Amy E. Buttell
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For every encouraging unemployment, housing or retail-sales report that came out in 2011, the following week or month brought equally discouraging news: Gas and food prices spiked, the stock market seesawed violently, housing and job markets stayed in the dumps. The economy technically emerged from the recession in July 2009, but it didn't feel like that in 2011.

What are the implications for 2012? Unfortunately, you should expect more of the same conditions this year.

Experts with whom we spoke don't agree on whether the economy will muddle along at a low growth rate or slip back into recession. And although the rate of inflation slowed, experts disagree on whether that will continue in 2012.

But that doesn't mean that everything's pitch black. Federal Reserve Board remains committed to reassuring markets that it won't make any abrupt changes in its interest-rate policies for the next 2 years at least. This means that if you have top-notch credit, you will continue to find rock-bottom auto, home-equity and mortgage loan rates this year. But low interest rates also mean that the value of your home will languish and you'll have to turn to the stock market to boost your assets in 2012. That brings its own challenges, because stock-market volatility is likely to persist. A few strategies and sectors should let you develop your stock portfolio, albeit by incurring some risk.

GROW OR NO? Like the Weebles kids' toy, the U.S. economy has been wobbling but hasn't fallen down. Economists are divided about whether that will continue this year.

After a recession, hopes are always high that the economy will bounce back quickly and return to an economic growth rate that will sustain job creation. Typically, that means a growth rate of the gross domestic product (GDP)—the total value of goods and services that are produced in the United States annually—of at least 3 percent. But in this environment of businesses and consumers who are committed to massive *deleveraging*—paying down of debt—that kind of growth isn't possible, says David Levy, who is chief economist of Jerome Levy Forecasting Center, which is an economics forecasting firm. For 2012 and possibly 2013, businesses, consumers and the government will be reluctant to spend.

“The issue isn’t that interest rates are too high; it’s that people don’t have the confidence to participate in the economy,” says Thomas Fox of Cambridge Credit Counseling. The same goes for businesses, and that reluctance means that stock investors shouldn’t expect significant growth this year.

Interest rates are at historic lows and are predicted to stay low in 2012. Levy repeatedly cut his forecast for the 10-year Treasury note, which he now believes will hit 1.5 percent in 2012. That means that people who are bent on saving will be out of luck when it comes to finding low-risk certificates of deposit and Treasury notes (read: investments that don’t involve the stock market) that have returns that will outpace the rate of inflation.

Because the economy was stuck in neutral for the second half of 2011, economists cut their 2012 GDP projections further. For instance, economists who participated in the Blue-Chip Survey, which has polled top business economists since 1976 about the economy, as well as economists at International Monetary Fund (IMF) now peg 2012 U.S. economic growth at 2 percent.

Other experts, however, predict a recession, including Economic Cycle Research Institution, which has a strong track record of predicting economic growth. Federal Reserve Bank of San Francisco, in an economic report last November, put the chance of recession at 50-50 through the first half of the year and diminishing as we head into 2013.

Analysts are keeping an eye on Europe’s financial problems, which are at the center of recession fears. Political wrangling over the bailout of Greece continued up through press time. Of course, the problems aren’t confined to Greece. Italy’s government leader was ousted in early November, and interest rates on Italian debt continued to rise. That’s bad for Italy, for the eurozone—the financial organization of 17 European Union countries—and for the global economy. Italy is a much larger economy than Greece is, and its bond market is the third-largest in the world, after the United States’ and Japan’s. If Italy can’t issue bonds on its own, other European countries might have to subsidize Italian debt.

The worry is that if Greece fails and Italy needs significant financial help, the European Union will go bust and trigger catastrophic global financial consequences.

“This has got to be the longest lasting, slowest-to-resolve crisis I’ve ever seen,” says David Twibell of Custom Portfolio Group.

EU leaders sought the financial assistance of the United States, China and other countries, but, as of last November, foreign governments haven’t provided assistance. Even if they do eventually, analysts question whether the amounts that are likely to be pledged would put the problem to rest.

Twibell also believes that relatively smaller events that are building within the United States could tip it into a recession: higher unemployment, a further deepening of the housing and foreclosure crisis, and poor corporate earnings.

Levy believes that a recession is coming in 2012. "We've been telling our clients to expect a recession," he says. "That could get pretty ugly with unemployment already at 9 percent—not including people who aren't even in the labor force. It's not a good situation."

The sum is an environment in which federal, state and local governments won't have the resources to fund major infrastructure projects and extensions of unemployment benefits that would jump-start the economy.

It's a mixed bag to be certain, but it seems most likely that the economy will slip into a mild recession this year. We don't believe that a 2012 recession will compare in size or scope with the Great Recession of 2008–2009, but a larger crisis in Europe would extend the downturn beyond a few months. This sounds like a broken record, but that doesn't change the tune: You should be prepared for suspense when it comes to holding on to your money in 2012.

UNCLEAR INFLATION. Inflation stood at 3.5 percent for 2011 as of last October. That's up from the 2010 average of 1.6 percent. Some economists and investment analysts fear that 2012 could bring *stagflation*, which is a toxic combination of low growth and high inflation that historically leads to persistently high unemployment and sky-high interest rates.

The Fed bought $600 billion in U.S. government bonds in 2011. Now Twibell and others, who include Federal Reserve Bank of St. Louis President James Bullard, are nervous that having that $600 billion pumped into the economy will spike inflation in 2012.

The cost of hospital services is up 6 percent and water costs are up 4 percent, according to the consumer price index, even though the economy is in weak shape, Twibell says. "It's scary that we're at 4 percent inflation in the last 6 months in the teeth of a second recession," he says. "What is it going to look like when we see some growth in the economy?" His answer is much higher inflation. Twibell says he wouldn't be surprised by an inflation rate of 5 percent or 6 percent in 2012.

Not everyone is as pessimistic. Levy expects U.S. inflation to be no higher than 3 percent in 2012, mainly because demand for consumer goods and wage growth are so low. The biggest factor in inflation, he says, is the cost of labor. "With tremendous downward pressure on wages and salaries, it's almost impossible for inflation to ignite," he says. Mark Zupan, who is dean of Simon School of Business at University of Rochester (N.Y.), sees moderate inflation in 2012, along the lines of the 3.5 percent inflation rate in 2011. But, he says, consumers should be prepared for prices to begin rising toward the end of 2012 and into 2013.

We wouldn't be surprised if inflation grows 3 percent to 3.5 percent for the first half of 2012, then creeps higher to end the year in the range of 4 percent to 5 percent.

That's bad news for savers, who have lost purchasing power, because return rates on high-quality fixed-income investments, such as certificates of deposit, have stagnated. In late 2011, average yields for a 5-year CD paid 1.73 percent, according to Bankrate.com.

"People who save are losing money every day, because interest rates aren't high enough to compensate for what they are losing to inflation and taxes," says Fred Dickson, who is chief investment strategist with brokerage firm D.A. Davidson.

It's a dilemma: If you leave the stock market to protect the money that you already have, you risk losing to inflation. But if you go the stock- market route, you risk the chance of further stomach-churning volatility and losses in your portfolio.

In this seemingly no-win scenario, experts say it makes sense to adopt a couple of basic strategies for 2012. First, you should put the money that you absolutely can't afford to lose—retirement plan, college-savings plans and savings—in a safe investment, such as a money-market fund, a short-term certificate of deposit or a bank savings account. Be aware that you won't make money and even will lose a little as inflation nibbles it away, but that seems to be a fair trade-off for peace of mind.

Second, for whatever amount that you can afford to risk, you should look to a combination of an absolute-return fund, a dividend-oriented mutual fund or dividend-paying stocks and a foreign-stock fund that has exposure to emerging markets.

Absolute-return funds, which sometimes are called total-return funds, seek positive returns that aren't relative to anything else and will give you steady returns of 6 percent to 8 percent without the volatility that you see in other funds, says Julie Murphy Casserly, who is a financial adviser with JMC Wealth Management. (Most mutual funds seek *relative returns*—returns that are better than those of a specific index. Such funds can boast that they performed well if they beat their index—even if the index fell 30 percent and the fund's return was down 25 percent.) Based on its longevity and track record, we believe that PIMCO Total Return Fund, which is the largest absolute-return fund, is a good option to consider in a tumultuous 2012.

Although absolute-return funds are helpful in an uncertain and volatile market, such as what you likely will encounter this year, a few caveats remain. You should know that these funds employ risky strategies—including short-selling, futures, options, derivatives, arbitrage and leverage—to achieve positive returns, regardless of the market. Also, if the stock market tanks, such funds are just as likely to decline in value as are other types of funds.

V FOR VOLATILITY. As you plan for 2012, you should recognize that the economy still is stuck in a multiyear muddle, says David Malpass, who is president of Encima Global, which is an economic research and consulting firm. Zero percent interest rates make bonds unattractive, he notes and yet, at the same time, high volatility makes stocks less attractive, too.

For 2012, the advice hasn't changed on what makes up a sensible investing plan: prudent diversification. (What the best diversification strategy is for you depends on your age and financial situation.) Diversification isn't foolproof, but investing in 2012 is all about avoiding unnecessary risks. As we mentioned earlier, a combination of safeguarding essential money and spreading the money that you can afford to lose among foreign-stock funds, dividend-paying stocks and stock funds, and absolute-return funds makes sense this year.

Stock-market volatility in 2011 sent more investors overseas to seek gains because of growth in China, Brazil and India, although inflation put somewhat of a damper on those markets' growth leading into 2012. For example, at press time, China's growth was projected to slip to 9.3 percent in 2011 from 10.3 percent in 2010; economic growth in India, likewise, was projected to decline to 7.0 percent from 10.1 percent; and growth in Brazil was expected to drop to 3.8 percent from 7.5 percent. Still, IMF and analysts project that developing economies, which include those above, will grow by around 6 percent in 2012, compared with projected growth of around 2 percent for the developed world.

However, in keeping with the continuing theme, in 2012, more risks are in investing overseas than at home. These risks include the potential that foreign currencies could fall in relation to the U.S. dollar, leading to a decline of the value of your investment. Political instability in Europe as well as in emerging markets, such as the Middle East, add to that risk this year, Twibell says.

And as for Europe, although we don't recommend going into a Europe-centered fund this year because of the continuing debt crisis, we believe that a broad-based international fund that has some exposure to Europe makes sense in 2012. The top performing fund over the past 10 years that includes Europe is Oppenheimer Developing Markets A (ODMAX), which has a diversified portfolio that includes Asia, Europe, North America and South America. We like that track record and the fact that it is managed defensively, so it tends to lose less money when markets are down than do other emerging-market funds.

TAKING STOCK. Because we expect that market volatility will be a continuing concern this year, investors should take a look in the rearview mirror. In other words, our advice from 2011 still applies: You should look for dividend-paying blue-chip stocks. Companies have to be stable financially to pay out income every quarter. Such stocks are suitable for both employed and retired investors this year and beyond.

Because of the uncertainty that shrouds 2012, it makes sense, too, to hold 5 percent to 10 percent of your investment portfolio in cash—or more if you don't have an emergency fund that could cover 3–6 months of living expenses. That cash reserve also means that you can jump in if buying opportunities are available in multinational blue-chip stocks that have strong track records, which we expect to be the case.

Because about 200 companies fall into the dividend-paying category, it's fairly straightforward to construct a diversified stock portfolio for 2012 across industries of companies that will yield about 3.5 percent annually. (That's much higher than the yields that most certificates of deposit, bonds and bond funds are expected to deliver this year. For instance, in late 2011, the 10-year Treasury note, one of the safest fixed-income investments that's available, yielded 1.97 percent.)

Josh Peters, who is an equity analyst at fund-data tracker Morningstar, recommends several dividend-paying stocks that make sense to buy in 2012, because they will yield not only dividends but potentially also capital appreciation. The names should sound familiar from our forecast of a year ago: Abbott Laboratories (NYSE: ABT), General Electric (NYSE: GE) and Procter & Gamble (NYSE: PG). Other stocks that have strong track records of paying dividends are AT&T (NYSE: T), Exxon Mobil (NYSE: XOM), Johnson & Johnson (NYSE: JNJ) and McDonald's (NYSE: MCD).

If you aren't keen to buy individual stocks, dividend-oriented mutual funds and exchange-traded funds (ETFs) are good options. One ETF that we believe will deliver in 2012—even in a shaky market, because it's been proven to stand up over the long haul—is Vanguard Dividend Appreciation ETF (VIG). This fund requires companies that are in its portfolio to have increased dividends for a minimum of 10 years. Others employ this strategy; Vanguard has the lowest expenses.

But if you can afford a bit more risk, the sector that's most likely to weather the volatility storm this year, according to the experts with whom we spoke, is technology. Their rationale makes sense: Companies that sit on large cash hoards and are reluctant to hire will spend money on technology to increase their efficiency.

The best of the technology bunch includes Microsoft (Nasdaq: MSFT). Because of its strong cash flow, it won't falter if financing gets tight again. Grady Burkett, who is a technology-stock analyst at Morningstar, holds out three other stocks. Oracle (Nasdaq: ORCL) and Symantec (Nasdaq: SYMC) are well-positioned to gain market share and increase their profit this year, he says. Cisco (Nasdaq: CSCO) is more of a turnaround story, Burkett adds, but has lots of cash, is growing steadily and in 2011 completed a restructuring that pared costs, which puts that company in a secure position in 2012.

COMMODITY CHANGES. Most experts with whom we spoke expect commodity prices for food crops, such as wheat, corn and soybeans, to continue to be moderate across the board. Consequently, companies that make food products should find it easier to achieve a profit. Moderate prices are expected to be the case for energy and gold, too.

Gold, after a historic run in 2011, is poised to fall, and energy prices aren't expected to be as volatile as they were in 2011, when they were affected by profound political instability in the Middle East.

Given the uncertainty in global economies, that view of commodity-pricing moderation seems solid. Because most investors' portfolios are heavily dependent on stocks and bonds, holding some commodities in 2012 makes particular sense to us—absent an economy-wrecking crisis in Europe. If that happens, and unfortunately, that's one of the major unknowns of 2012, being diversified in commodities won't help your bottom line.

A good commodities strategy for 2012 is to invest in index funds and ETFs that are based on the Dow Jones-UBS Commodity Index. Jeff Nauta, who is a manager at Henrickson Nauta Wealth Advisors, says the commodities that are in that index are weighted, so energy isn't too large of a component in the index, which makes it less volatile.

Consequently, you might consider the iPath DJ-UBS Commodity Index Total Return ETN (DJP), because it's an exchange-traded note that's based on the index and isn't leveraged, as are the other ETFs that are based on this index. Highly leveraged funds can be volatile and might decline rapidly during down markets.

For 2012, U.S. Energy Information Administration (EIA) expects oil prices to average around $95 per barrel, but prices could go as high as $115 or as low as $70 per barrel. That volatility echoes what happened in 2011, when prices ranged from $78 to $114 per barrel. Meanwhile, natural-gas prices are expected to be fairly stable in 2012 because of an abundant supply, EIA says. Thus, it seems prudent to us to avoid betting too much on energy-specific stocks or ETFs—particularly those that concentrate on production, such as large oil and gas companies. Instead, the least risk is to invest in companies that operate the grid through which energy travels, because energy producers must get their product to market in 2012 no matter how the economy is doing.

Casserly believes that Kinder Morgan Energy Partners (NYSE: KMP), which owns and operates pipelines, storage facilities and terminals, is in a strong position for 2012, because last fall it merged with rival El Paso and can take advantage of infrastructure demands.

After energy, gold is one of the most popular commodity investments. Gold, which is a traditional investment when people are uneasy about the economy, has been on a major tear since 2008. It peaked last August at $1,917 per troy ounce after it started that year at $1,400 an ounce. As of press time, the gold price had slid to $1,778 an ounce.

Where will gold go in 2012? Experts with whom we spoke disagree, and that debate is based on the "if" of whether the economy slides into a recession. Given the drop in the price of gold from its peak last summer, we believe that you should approach gold with caution in 2012. In other words, if you have gold in your portfolio, hang on to it but don't add any more.

HOUSE HUNTERS. By the end of 2012, 10 million foreclosures will be completed, according to RealtyTrac, which is a foreclosure-tracking firm.

In the face of that grim news, administration officials last October changed the Home Affordable Refinance Program (HARP), so borrowers who had mortgages that were sold to Fannie Mae or Freddie Mac through May 31, 2009, will be able to refinance no matter how far underwater their loan is.

Analysts with whom we spoke are skeptical that the program will come anywhere near to meeting the target of helping more than 1 million homeowners. Eli Tene of Peak Corporate Network, which is a group of companies that handles complex commercial real-estate transactions, notes that the program helps neither the estimated 6 million borrowers who are behind on their loans nor the homeowners who are underwater who have second mortgages.

What's worse, Alan Sims of Center for Litigation & Consumer Real Estate Education believes that many of the homeowners who are eligible will be required to sign up for extended mortgage terms that could last up to 40 years, depending on how far underwater that they are, or they will be asked to make a substantial balloon payment at the end of the mortgage term.

To bolster the housing market, The Fed last September embarked on Operation Twist, in which the government buys long-term bonds with the goal of lowering mortgage rates. As a result, 30-year mortgage rates fell to 4.02 percent as of press time. The program is scheduled to run through June and might drive mortgage rates even lower. Based on conversations with experts, we believe that 30-year mortgage rates could fall to as low as 3.5 percent, with 15-year mortgage rates falling to near or below 3 percent.

But if inflation rises, as we expect that it will, particularly in the second half, The Fed likely will move to raise rates in 2013. So, if you can qualify for a purchase or a refinance, this year is the time to do it. When inflation rises, so will interest rates. If that happens, it likely will be several years before interest rates fall again.

In mid-November, Congress voted to increase federally guaranteed loan limits to help the housing market. That limit was reduced to $625,500 from $729,750 last October. The November vote reversed that reduction and should benefit prospective homeowners in regions where housing prices are high, such as California and New York. These regions could see lower interest rates and looser lending standards.

If you're in a position to pick up a bargain home in 2012, *short-sale opportunities*—homes that are being sold by banks when homeowners can't make their payments—will abound, because more homes are entering the foreclosure process this year, and banks will continue to do whatever they can to get homes sold and off their books. The top short-sale markets are in parts of Arizona, California, Florida and Nevada, according to RealtyTrac.

And, in the bleak housing market in 2012, if you find yourself in a position to score a bargain, that's something to write home about.

Amy E. Buttell has written for 12 years about the economy, personal finance and financial planning for consumer and trade publications. She doesn't hold any positions in any of the investments that are mentioned in the article.

Job Prospects: More Struggles, Few Smiles

The employment outlook for 2012 is bleak. Even the most optimistic of predictions about U.S. economic growth this year won't create the jobs that would be necessary to significantly lower the unemployment rate.

That's only part of the woes, says Thomas Fox of Cambridge Credit Counseling. He notes that a striking feature of the Census Bureau Report on Poverty, which was issued last September, was that 2 out of every 5 poor people were employed. "That's where the issue is," Fox says. "You can have jobs, but are they going to be quality jobs?" In other words, available jobs likely won't pay much. (Research from National Center for Children in Poverty suggests that a family of four needs an income of $40,000 to make ends meet.)

Manufacturing jobs that provided long-term secure employment for millions are gone for good, says Kathy Kane of Adecco, which is a human-resources-management company. Kane predicts that health care is the one field that will create jobs regardless of how the economy is functioning. Unfortunately, she says many of those jobs will be for physician assistants and nurse practitioners—positions for which you'll need extra training and licensing to land.

Election 2012 Overshadows Economy

As Republicans jockey to face President Barack Obama in November, few observers expect much of anything to happen out of Washington to bolster the economy in 2012. That's because the Republicans, who control the House of Representatives, are determined to block the Democrats, who control the White House and the Senate, from accomplishing anything that would burnish their election credentials. Likewise, the Democrats don't want to give the Republicans any ammunition in terms of accomplishments to bring to the electorate during the election season. We expect that "obstructionist" will be a well-worn label in 2012.

If the election results in a continuation of the status quo, more gridlock is likely. And even if one party wins a clear mandate, the impact of the newly elected politicians' decisions, of course, won't be felt before 2013.

"Just as the market has high volatility, there's a polarization of the policy directions of the two parties that shows up every day on the argument over whether the federal government should spend more or less," says David Malpass, who is president of Encima Global, which is an economic research and consulting firm.

"Historically, the year of a presidential election is positive for stocks," says Jack Hillis of Hillis Financial Services. However, neither he nor the other experts with whom we spoke were willing to make specific investment picks: They say so many possible scenarios emerge when you weigh presidential and congressional elections and economic volatility that to make recommendations now would be like throwing darts at a dartboard.

What You Should Know About the Next 'Crisis'

The political brinkmanship over raising the U.S. government's debt ceiling last summer sparked concerns that credit ratings would plummet and thus trigger a rise in interest rates on government bonds and on all types of loans. Standard & Poor's reduction of its U.S. debt rating to AA+ from AAA jolted the markets, but the ultimate impact was negligible. Virtually all of the analysts with whom we spoke believe that the United States has the capacity and willingness to repay its debt.

Unfortunately, the debt-ceiling issue also wasn't resolved, so you'll see more brinkmanship in 2012. A deficit-reduction supercommittee was to report specific recommendations at the end of

November but failed to meet its deadline. Members of the committee from each political party presented plans to reduce the national deficit, and each plan was deemed "dead on arrival" by members of the opposite party. That failure means that, beginning in 2013, $1.2 trillion in cuts to Medicare and defense spending are to occur automatically. However, politicians already were vowing to fight those automatic cuts.

The opening sessions of Congress this year likely will be spent dissecting that report and deciding on a package of cuts that can make it through Congress and gain the president's signature. But because the two parties disagree greatly on spending cuts and tax increases, that battle could drag on for months. Whatever cuts and tax increases result aren't likely to be implemented until after the presidential election in November or in 2013.

The experts with whom we spoke don't believe that you should rearrange your portfolio based on whether the $1.2 trillion in cuts still loom in 2012, because the budget cutbacks already are priced into the market, and because this past year's debt-ceiling crisis had a limited effect.