March 2012

CHECKMATE

Market Updates, Perspective, News and Context

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CAUTIOUS OPTIMISM, INCREASED DANGER

2012 Market Forecast

By Thomas K. Brueckner

Ronald Reagan once quipped that, "Ivy-league economists have predicted 12 of the last five recessions." Reagan, who had a degree in economics, was an optimist and was zinging their incessant pessimism over his policies. Today, with an investing public desperate for good news, an updated version would be that brokerage-employed economists have predicted 12 of the last five *bull markets* and are in danger of becoming *permanently* bullish and merely shills for the major brokerage firms.

Last year is a case in point. As the chart (P.2) shows, every single one of the "most-respected" economists listed erred *to the high side* in their estimate of where the S&P 500 would finish the year. What do they all have in common? *They all work for a major brokerage firm*, where the goal of each employee—from the marketing department to the CEO—is to bring new "assets under management" into the firm. Imagine an economist who said publicly, "This year is going to be

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Welcome to the premiere issue of Checkmate, a quarterly newsletter from Thom Brueckner and his staff featuring market updates, news and information we think is important for you to know.

STRATEGIC ASSET CONSERVATION

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bad; whatever you do, *don't* place your money with us until the market improves." Such honesty might have a place at a major think tank, but not on Wall Street amid the current climate.

Last year was *The Year to Nowhere* in US markets. The S&P 500 began 2011 at 1258 and, after wild 20 percent swings over mere weeks, ended the year unchanged at 1258. The NASDAQ was down -2 percent, and the Dow (DJIA of only 30 weighted companies) was up 6 percent.

The last 12 years have taught us a lot, as investors and as advisors. Unfortunately, not everyone is applying those lessons to their finances as they should. One of our unwavering convictions as fiduciaries on behalf of our clients today, is that we have ceased trusting any forecaster who didn't see the Financial Meltdown of 2008 (-57 percent) coming. Like a weatherman who predicted warmth and sunshine for the weekend that yielded The Blizzard of the Century, I simply can't trust the "professional" judgment of such a person or organization. (Ex: Several of the major ratings organizations still had Lehman Bros. rated "A" on the day it failed.)

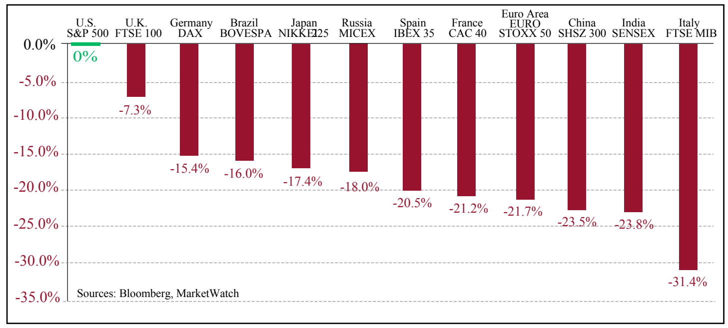
Abbey Yosef Cohen	Goldman Sachs	1500
David Kostin	Goldman Sachs	1450
James Paulsen	Wells Capital Management	1425
Barry Knapp	Barclay's Capital	1420
David Bianco	Bank of America/Merrill Lynch	1400
David Kelly	J.P Morgan Funds	1400
Henry McVey	Morgan Stanley Investment	1363
Bob Doll	Blackrock	1350
Laszlo Birinyi	Birinyi Associates	1333

Source: Barron's, Bloomberg

2011 Year-End S&P 500 Target Predictions
Actual 2011 S&P 500 Year-End Value: 1258
Notice that *every* forecast was *higher* than the actual...

So here we are in mid March, with Europe entering a recession, the European Central Bank (ECB) and the International Monetary Fund still looking for a way to save Portugal, Ireland, Italy, Greece and Spain from default—and their Euro currency too—amid slowly improving economic numbers in the U.S., and what promises to be a very contentious political season directly ahead. What are we to conclude about the direction of the markets, whether for the purpose of reallocating our safe-money holdings, or for our remaining risk-exposed assets?

The chart below shows where world markets ended 2011. As you can see, in the beauty contest between world markets, America is winning, not because our economy is especially gorgeous, but because it's the least ugly.



Amid Global Volatility, Flat US Market Was 'Least Worst' in 2011

The following is our 2012-13 summary of some of the key predictions of our favorite (most accurate) market research firms, as well as those of seven individual economists who accurately predicted the 2008 financial collapse:

- 2012 will see the 27-nation EU slip into recession, without ever recovering from their 2009 recession. Growth in the US will be 0-1.5 percent, and could turn negative by mid-year.
- 2012-13 will see a "vicious cycle between sinking banks and sinking sovereign countries. The world's largest banks are up to their eyeballs in the bonds of failing countries."
- The Eurozone economies cannot handle both sovereign *and* banking deleveraging at the same time. Absent the ECB's willing role as lender of last resort (lots of Euro-printing), a 2008-like crisis will ensue.
- Fitch, Moody's, and Standard & Poor's will downgrade 6 euro-zone countries in 2012, in addition to Goldman Sachs, Bank of America, Morgan Stanley, and five other banks.
- China (-23 percent in 2011), Brazil (-16 percent), and India (-23 percent) were responsible for 77 percent of global growth in 2011. *Their simultaneous slowdown bodes ill for 2012*.
- U.S. markets will benefit from capital inflows from recession-strapped Europe throughout most of 2012, offset by lost U.S. profits amid declining European trade later in the year.

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- Political instability will escalate in Europe, the Middle East and certain emerging market nations in 2012, as austerity programs are implemented to prevent entitlement defaults, and state benefit cuts leave many impoverished.

- The U.S. presidential election of 2012 will be the most contentious in U.S. history, with protest rallies impacting financial markets in Q3 and Q4.

In short, 2012 could go either way, modestly or wildly, and the historic 17-year bear market cycle that we're still in is alive and well with roughly 5 years to go. While this year could well yield some nice gains, we'd all be wise to buckle up. This isn't over yet—and any gains could well prove to have been mere "head fakes," compression rallies that the markets will just give back in a year or two. If you have friends who are fully invested right now, they may wish to take some money off the table. ■

Sources: Weiss Research, CBO, Casey Research, Stratfor, Peter Schiff, Brett Arends, Nouriel Roubini, Mike Larson, et al.

THE BEST ECONOMIC INDICATOR YOU'VE NEVER HEARD OF-

What in the World is the BDI?

By Thomas K. Brueckner

There are many economic indicators that employ data from the recent past to predict our economic future. Alan Greenspan once likened his job as Federal Reserve Chairman to "driving a car through the rear view mirror," not an enticing proposition at high speeds on a winding mountain road, never mind for a $15 trillion economy with debts equal to that, in a world with few certainties.

Other indicators, such as Consumer Confidence, measure sentiment, i.e. the fickle, nebulous sense of the public's mood as it applies to what it has been told in recent weeks about inflation, unemployment, who won the Super Bowl, and a host of other factors. Most of these "indicators" are guesses at best, later revised up or down, not unlike the horrible[1] 25-year record of the equity analysts and brokerage-beholden economists on Wall Street.

What if there was a global indicator that actually forecasted the future by looking—oddly enough—at the future? If you haven't already heard of it, allow me to introduce the Baltic Dry Index (BDI), a measure of the future demand for shipping, not of finished products, but of the very raw materials (cement, iron ore, wheat, coal, and building materials) that counties order from one another based upon anticipated orders and future need. The BDI is totally devoid of speculative content; industry leaders worldwide don't book freighters unless they have cargo to move, based upon anticipated demand within growing economies.

So why are we educating you about this now? *The BDI has fallen a staggering 61 percent since last October.* And on February 4th, the index dropped to a new all-time low of 647—a 94.5 percent decline from its all-time high of 11,793 just over three and a half years ago.

The Baltic Dry Index: Predicting World Recession?

Before we all panic, however, a word of caution: While the BDI is a compelling indicator of economic conditions around the next corner, it is also influenced by geopolitical tensions like, for example, Iran's recent saber-rattling over a military closure of the Straits of Hormuz, the narrow waterway through which 40 percent of the world's oil, alongside other commerce, flows each day. If industries become concerned about lost cargo amid military tensions in the region—or full container ships are anchored idly in international waters, unable to deliver their loads while the cost of insuring that cargo becomes prohibitive—orders for shipping will logically decline.

Bottom Line: It doesn't really matter *why* the BDI has tanked, it only matters that it has. The fact is that shipping demand is at a 25-year low, even lower than the bottom it reached during the Financial Meltdown of 2008. With many predicting European recession, this reliable indicator may be telling us that the worst may not yet be behind us. ■

[1]As researched by McKinsey & Co. and reported by Reuters, equity analysts have been overly optimistic for 25 years. Their earnings growth estimates averaging 13 percent annually, compared with actual growth of 7 percent, were almost 100 percent too high, in rolling five-year cycles going back to 1985.

THE GEO-POLITICAL CORNER

Israel, Iran, and the Coming Spike in Gas, Oil Prices

By Thomas K. Brueckner

Last year, savvy market watchers began warning of the effect on world markets, should Israel preemptively attack Iran's ballistic missile capability in the Persian Gulf. As has been widely reported, Iran is now within one year of developing a nuclear warhead, and has recently tested its missile range capabilities. Iran has also threatened a naval blockage of the Strait of Hormuz, the narrow waterway between the horn of Africa and the Iranian coast through, which 22 percent of the world's oil passes each day.

Israeli Prime Minister Benjamin Netanyahu, both in discussions with President Barack Obama and in a passionate speech delivered to AIPAC, stated unequivocally that "Israel reserves the right to defend itself from threats to its people and homeland." Netanyahu also said the window of opportunity to prevent war in the region is rapidly closing—and "can be measured in months, not years." Netanyahu reiterated Iran's stated goal for the annihilation of Israel, and Iran's official state denial of the Holocaust, as reasons why the international community should take the situation seriously.

The strategic options available to each of the parties in this rapidly-gathering storm are an interesting study. While some observers believe that Israel must act *before* the U.S. presidential elections in November, others (myself included) believe that it's in Obama's political best interest to act *ahead* of Israel—rather than reacting to the outcome of an Israeli attack of which they were not informed beforehand. We believe that the Israelis simply don't trust the White House not to leak information ahead of an attack, and that preserving the element of surprise mandates a solo strike.

Simply put, while Obama maintains that "all options (including military) are on the table," the Israelis "wonder if the Administration even knows where the table is," according to former U.N. Ambassador John Bolton, "and simply cannot wait for them to figure it out" while Israel comes ever closer to an imminent threat of attack.

So when would either country likely strike preemptively? Some believe that if Obama strikes first, it can't be shortly before the election. Republicans would most likely accuse him of staging "an October Surprise" to rally Americans to the flag and his presidency on the eve of our election. That said, it cannot be too early in the year, as the resulting spike in world oil prices would sink our summer vacation/driving season and perhaps our fragile recovery with it.

However, a late-August strike has several benefits: The gas in our tanks will already have been paid for, an America mostly on vacation is a distracted electorate, it would be early enough for gas prices to possibly recover before the November elections, and it diffuses the accusation of his attempting to shore up his personal approval ratings on the backs of our air and naval forces. We are also reminded that Obama could simultaneously release a portion of our own Strategic Petroleum Reserves, as a means of flooding the American market with available oil, thus keeping gas prices somewhat stable at home in the aftermath of an air attack on Iran.

Another possibility is a *joint* preemptive attack, but this carries with it the potential loss of secrecy required of such an undertaking. Netanyahu knows what Ben Franklin once claimed, namely that "three can keep a secret, so long as two are dead." Israel would rather not share precious intelligence with an Administration that, only months ago, suggested that Israel return to its pre-1967 borders; thus giving up the strategic Golan Heights from which an attack could again be launched against them.

What's the most likely outcome? Sanctions won't work; especially when sparingly applied, Iran will again defy the western democracies. In the end, an Israeli Air Force armed with irrefutable intelligence will attack the known locations of Iran's ballistic missile launchers, setting the Middle East ablaze with Muslim anger now redirected at Israel. Oil prices would immediately rise 15 to 30 percent, markets around the world would scurry in retreat, and the U.S. would join a Europe that is already in recession—on the eve of what promises to be the most contentious presidential election in our history.

Considering all this, you may be thinking, is it time to buy stocks "because the economy is finally showing signs of life?" We're thinking not just yet. ■

Word Of the Quarter: Austerity

Austerity; a code word, especially among those on the European left, for a curious belief in the right to have other people's money—coupled with a sense of outrage if those same people dare to offer advice as to how that money should be spent.

- Jason O'Mahony, columnist for MarketWatch, writing about the European Debt Crisis, February 16, 2012

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