

As we head into the end of the year, hopes are rising among investors for a reprieve from the roller coaster ride in the markets, which has featured twelve 7% swings in the S&P 500 in the past five months.



The ongoing crisis in Europe has been the principal cause of recent volatility. The latest downdraft culminated the week of Thanksgiving, when Europe seemed on the verge of financial collapse. The subsequent “risk-on” euphoria of the past week has been based on hopes for the latest installment of the European rescue plan, as well as coordinated actions by the major global central banks to provide liquidity and stimulus.

Italy is a case study of how quickly a country with a suspect debt structure can go from perceived solvency to perceived insolvency. Italy also illustrates the degree to which overly indebted governments (which represents most of the developed world) are dependent upon the maintenance of low interest rates. Hence, the calls for the European Central Bank (ECB) to intervene to cap bond yields as the Federal Reserve has done in the U.S.

Italian short-term government bond yields have fluctuated wildly in recent weeks, and have become a key barometer in assessing the current state of the European crisis. The two-year Italian government bond yield reached a high of 7.9% on November 25, up from 4.6% just a month earlier. At present, the bonds are trading at a not-so-alarming yield of 5.6%, as European bond markets have stabilized in anticipation of bold policy action this week.

The bar is set at a high level for European policy makers to unveil a credible plan at the end of this week at what has been described as a “make or break” EU summit meeting. Rallying markets reflect expectations that policy makers will do enough to quell this particular phase of the crisis and, at a minimum, postpone problems for awhile.

Hopes now revolve around a deal in which expanded support from the ECB is conditioned upon centralized fiscal control. Germany wants profligate countries to submit to stricter fiscal rules and enforcement mechanisms in exchange for aid. Last Friday, German Chancellor Angela Merkel called for rapid EU treaty changes to allow greater EU control of national budgets.

Germany and the ECB are loath to follow the U.S. policy of fighting debt with more debt. They have dismissed quick fixes such as massive Fed-style money printing by the European Central Bank. They correctly point out that an ECB bailout would remove the pressure on profligate governments to enact the necessary reforms.

Speculation in the markets is that Germany is willing to see the ECB step up its buying of troubled Euro zone countries' bonds as a bridging measure until budget controls take hold. ECB President Mario Draghi opened the door last Thursday to more aggressive action to help fight the euro zone's sovereign debt and banking crisis *if governments adopted a new "fiscal compact"*. In other words, expanded ECB purchases of distressed European debt will be predicated by an agreement on European fiscal integration.

If in fact the EU is on a path towards fiscal integration, it would address the EU's fundamental flaw, exposed long ago, of a monetary union without a fiscal union. But fiscal integration presents an enormous political challenge. It is hard to see how EU member countries can agree, especially in a short period of time, to a framework for ceding fiscal authority. Will it be possible to impose stricter fiscal rules when they haven't even been able to enforce the fiscal rules now in place? The voters in the overly indebted countries may ultimately decide they would rather default and exit the EU than submit to the required fiscal austerity and loss of sovereignty.

Market Comment

Europe continues to occupy center stage, but it is just one of many troubling issues confronting investors. China faces a potential “hard landing.” Geopolitical risks in the Middle East have been escalating. Recession risks in the U.S. are still running high, despite somewhat more positive recent economic reports. Our dysfunctional politics continues to sap confidence and postpone urgently needed reforms. Investors have grasped the magnitude of the debt problem here and abroad and the reality that there is no easy way out. It is important not to be unduly focused on the macro environment, but the current backdrop certainly is daunting.

Given the barrage of bad news over the past several months, it is impressive that the S&P 500 is about even for the year, which can be explained in part by the pitiful yields on cash and high-grade bonds. We are now in a favorable seasonal period for the stock market. Volatility may be settling down after the roller-coaster of the past four months (see chart below). If the EU can put forth a credible plan that placates markets for awhile, stocks may push higher into the end of the year. There will be a flurry of policy announcements over the next two weeks from the EU, the ECB, the Fed, and the U.S. Congress (regarding 2012 fiscal policy). We will have a much better idea where things stand at mid-month, and plan to distribute an interim market comment at that time, which will include our thoughts on asset allocation as we move toward 2012.

