



After huge volatility, the S&P 500 index ended 2011 where it started.

- **Smaller and mid-cap stocks closed the year down 4.2% and 1.7%**, respectively, despite also posting double-digit fourth-quarter gains.
- **Foreign stocks were down 14.8%** due to fear over Europe and slowing growth in China
- **Emerging-markets stocks fell 20.41%** as a result of China concerns and a flight from risk
- **High-quality bonds were up by 4.8%** for a full-year gain, with sharp flight-to-safety rallies.

The huge amount of debt in the developed world continues to create enormous uncertainty and to drive our expectations about the years ahead. As most of the developed world struggles to dig out from under a mountain of debt, all options involve economic pain compounded by political uncertainty. **In addition, while the U.S. economy is improving, structural risks remain and Europe has already entered another recession.**

Three Major Scenarios:

Slow growth? Most likely. Global recession? Less likely. Stocks rally? Don't count on it.

We continue to utilize a scenario analysis to understand the range of possible outcomes over multi-year timeframes, which can be assessed more reliably, to enable us to gauge risk and reward for our clients' investment needs that last beyond one year. As such, **we believe there are three major scenarios for the years ahead: slow growth, global recession or possible, but unlikely and short-term, stock rally(ies).**

- **In our base-case scenario, there is no major financial crisis, but growth remains slow in the years ahead due to ongoing headwinds from deleveraging (read paying down debt, defaults, bank failures, bankruptcies) and we continue to see elevated volatility.**
- **We believe the risk of our most negative scenario, in which a financial crisis in Europe leads to a global recession, increased in the fourth quarter.** We still believe this is somewhat unlikely, but we cannot rule it out; and because it would have a major impact if it occurs, we must take into account both its odds and the level of damage it would cause.
- **If European policymakers are able to coordinate on measures to address their growing financial crisis and there are continued positive signs from the U.S. economy, stocks could rally.** Given current stock prices, we think this is the least likely scenario and any such rally, should it occur, would most likely be short lived as prices return to the mean.

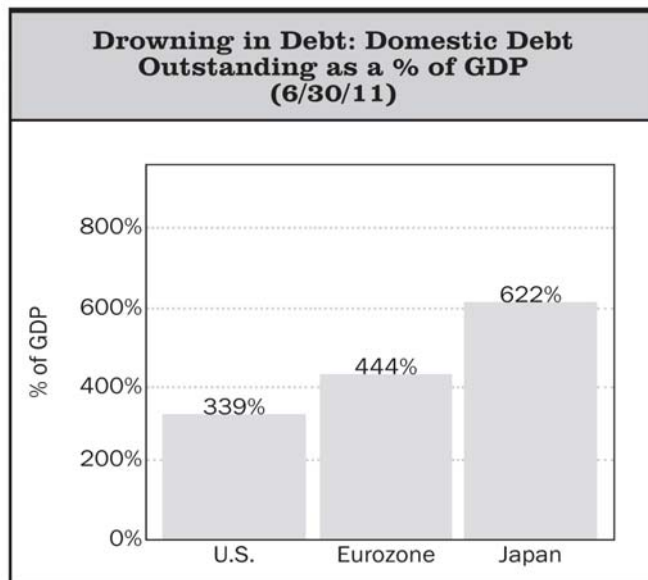


We remain cautious, as we do not view equities, broadly speaking, as offering potential returns commensurate with the risks we assess them. We believe, given the potential damage of a European financial crisis, it is more prudent to take some risk off the table and wait for more attractive opportunities; we have, therefore, reduced weighting to equities. Clearly underweighting equities means we will under-perform during stock rallies. It also means we can take advantage of declining stock markets and increase our equity positions at lower prices. We continue to be confident that our positioning over a multi-year timeframe enables us to be ready to take advantage of opportunities.

An Era of Deleveraging

As most of the developed world struggles to dig out from under a mountain of debt, all options involve economic pain that is compounded by political uncertainty. Having hit debt levels that are unsustainable, deleveraging (debt reduction relative to gross domestic product, GDP) is necessary. Ideally, this comes from economic growth as occurred in the United States following World War II when 1946 debt was 125% of GDP or (for those of you who are good at math)—increasing the denominator in the debt/GDP ratio. But **when debt is so high, it becomes a headwind to growth.**

Governments try to use fiscal stimulus to counterbalance the private sector’s retrenchment; but this can only continue for so long, as increased government spending/stimulus adds to the growing burden of public debt. So, that leaves spending reductions and tax increases as solutions at the government level (austerity), or some degree of debt default. Default can happen in two ways: (1) not repaying debt, or (2) creating inflation by “printing” money so that money is devalued. Both of these options create other problems.



Sources: U.S. Federal Reserve, Bank of Japan, and Eurostat.

Governments can also attempt to force “financial repression,” where they use all possible tools to keep interest rates low. This serves several purposes including keeping their borrowing rates low so that the debt-service burden does not explode to impossible levels. For investors, this means low returns from fixed-income investments.

The lesson from economic history is that, without exception, a debt-induced financial and banking crisis results in a lengthy period of subpar economic growth. This is exactly what has been happening throughout the developed world economies since the 2008 financial crisis.



Weak economic growth leads to periodic recession fears and unacceptably high unemployment. Moreover, high debt levels mean that we will likely be living with huge macro-level risks for a few more years at least. If we are right, it is probable that we will experience (1) continued high financial market volatility and (2) reduced investor risk appetites, meaning lower prices for risk assets like stocks and high-yield bonds than would otherwise be the case.

Multiple Risk Factors

There are many debt-related risks in the world today. Europe is an obvious big risk in the near term and, as the sovereign debt situation has worsened, it has increased the chances of our most negative scenario playing out, deflation. **While Europe, like the U.S., has a central bank it, unlike the U.S., does not have a common fiscal policy.** What we're seeing in Europe is investors are afraid that the region lacks the political unity and possibly even the financial capacity required to provide a sufficient financial backstop for the Eurozone. That increases the risk of weaker governments defaulting on their debt, which makes investors demand higher yields for taking on that risk. Those higher yields contribute to an adverse feedback loop that makes a default even more likely, because governments can't sustain interest payments above a certain level, so only some type of unified policy action and intervention can allow governments to roll over all the debt that is coming due.

It is very possible that we will find out during the next year whether Europe can keep the EU together and get through the crisis with a mild recession or, at the other extreme, whether we will see an EU collapse triggering defaults in the trillions of euros, a 2008-type banking crisis, and possible European or even global depression. There are other outcomes in between these two extremes. Most economists now view recession in Europe in 2012 as almost certain. European authorities have so far been ineffective in containing the crisis through incremental steps. The worsening of the crisis actually increases the likelihood that the European Central Bank will finally step in more decisively and provide major support for the sovereign debt market and the banking system, e.g., by buying Italian and Spanish government debt via "quantitative easing" (much as the Federal Reserve has done with Treasuries) to bring down interest rates, restore confidence, and break the debt-contagion adverse feedback loop. But, this is not certain and the question of whether they will do it in time to avoid a serious and potentially devastating economic downturn is one we can't confidently answer. The costs of a European Union break-up are high so there should be strong motivation to avoid it, but the political and practical realities are highly complex.

As we enter 2012, stress on the banking system is intensifying and banks are downsizing by aggressively reducing lending, selling assets, and pulling out of many markets as funding has dried up and assets on their balance sheets have become riskier and less valuable.

Their actions are being felt around the world. In short, there is already a European banking crisis though not yet as severe as what we saw in 2008 in the United States.



The global ramifications of a disorderly EU breakup would likely be severe. The banking system would be a primary way to transmit the crisis globally and trade would be a secondary transmission mechanism. Though most of the direct exposure to default is with European banks (and they also operate in the U.S. and around the world), U.S. banks have exposure through derivatives (a financial instrument whose price is derived from the value of another asset or group of assets). Unfortunately, there is a lack of transparency that makes it impossible to fully understand the nature and amount of the derivatives risk to U.S. banks. (We have seen estimates that exposure through counterparty risk—the risk that the other party to a derivatives contract does not live up to its obligations—is as high as \$4 trillion.) The likely result of this scenario would be at the very least a developed world recession, as credit could temporarily freeze and trade levels would drop. This would also result in a slowdown in some emerging economies and outright recession in others. Heightened risk triggered by concerns about sovereign risk could also trigger a funding crisis. According to the Organization for Economic Co-operation and Development, developed countries will need almost \$11 trillion in funding in 2012—mostly maturing loans needing to be rolled over. Normally this would not be a problem. But a European meltdown could conceivably trigger market pressure on the heavily indebted U.S. and Japanese economies (though capital has to go somewhere and U.S. Treasuries remain the asset of choice in times of heightened risk aversion).

Policy tools would likely be more limited than in 2008 and 2009 because we've already used up some of our "bullets," contributing to government debt levels that are very high and that could reduce the political will to allow them to expand further. *We view this overall scenario as less likely because the ramifications are so extremely negative that authorities will want to avoid it at all costs. However, we have learned not to dismiss the unthinkable and we are not able to have complete confidence in policymakers taking effective actions at the right time.*

While Europe is the imminent risk, there are other worries. The U.S. economy, though still weak, has performed somewhat better recently and appears to have moved back above stall speed. But, 2012 will be a year of fiscal contraction with the amount still uncertain as we write this. If a European meltdown can be avoided, it is expected that the United States will continue its slow expansion, but our own maddening political dysfunction, severe debt problems, and continued housing weakness makes the United States susceptible to economic shocks and policy errors. **(The Fed is conducting another round of stress tests on banks and their worst-case assumptions are telling: 13% unemployment, a 21% decline in home prices, and a 52% peak-to-trough decline in the stock market.)**

China and Japan

Japan is one of the most indebted developed countries and highly susceptible to rising interest rates. China's economy is slowing and the authorities are now moving to stimulate growth.

But, the impact of its previously booming real estate sector, which according to some reports is now contracting at disturbing levels in some regions, and slowing export growth to the



developed world, remain serious risk factors. We can't confidently predict whether China will be able to avoid a sizable slowdown in growth (a "hard landing"). But, we are concerned, because of the importance of China's impact on global growth, which has been disproportionate to their portion of the global economy. (Based on World Bank data, in 2010 China accounted for almost 20% of global growth.) A hard landing for China would be a significant blow to the developed world economies. And, yet another risk to the global economy as we move into 2012 is the possibility of rising Middle East tensions (with Iran specifically) driving up the price of oil.

So Where Are We? Our Portfolio Strategy

We have managed through many challenging environments; however, none has been more challenging than the recent financial crisis in 2008 and the aftermath that continues. **The weight of the evidence suggests to us that it is right to be cautious. Overall, our decision is to reduce risk across our balanced strategies.** We accept the risk of trailing under some scenarios for a number of reasons:

First, **while the odds of a very negative scenario playing out are relatively low, its effects would be highly damaging, even devastating.**

Second, **we think our optimistic scenario of a significant and sustained rally is unlikely.**

Third, our most-likely scenario involves no crisis but slow growth for many years, with mediocre returns for stocks (in the mid-single-digits), and periods of high volatility **that will create opportunities to add back stocks at more attractive prices.**

Fourth, our process and the decisions that result reflect our commitment to thorough research, intellectual honesty, and discipline, and we believe this kind of process has the best *long-term* likelihood of success.

We continue to be confident that our positioning over our multi-year time frame is appropriate for the current economic and market conditions and remain ready to take advantage of tactical opportunities in the markets should they arise.

The Opis Advisors, Inc. Investment Commentary is mailed quarterly to our clients, accountants, attorneys and anyone interested in our views. Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by Opis Advisors, Inc. with permission. Reproduction or distribution of this material is prohibited and all rights are reserved.



Opis Advisors, Inc.

Opis Advisors, Inc.® is a Registered Investment Advisor providing investment advisory services. We do not receive commissions or transaction fees of any kind including commissions on the purchase, ownership or sale of securities. Fees are based on a percentage of assets.

Disclosure: Alan Campbell is a Registered Representative with Securities America, Inc., a Registered Broker/Dealer and Member of the FINRA and SIPC. There is no affiliation between the Opis Companies® (Opis Advisors, Inc.®, Opis Insurance Services, Inc.® and Opis Retirement Consultants, Inc.®) and Securities America, Inc. Those seeking “traditional” investment brokerage services, where the broker receives commissions as opposed to fees, may do so through Securities America, Inc. and may choose to appoint Mr. Campbell as their broker. Securities offered through Securities America, Inc., a Registered Broker/Dealer, Member FINRA and SIPC, by Alan H. Campbell, Registered Representative, California Insurance License #0775396. Securities America, Inc. and the Opis Companies are unaffiliated. The Opis Companies and Securities America, and their representatives do not provide any tax or legal advice. Investors must consult with the appropriate advisor for information concerning their particular situation.

Currently Mr. Campbell is licensed to offer securities in Arizona, California, Florida, Hawaii, Idaho, Montana, Nevada, New York, Oregon, Utah, Washington and Wyoming. Those residing in other states would be able to conduct investment business with Mr. Campbell subsequent to his seeking and receiving approval to do so from those respective states, a process that normally takes less than two days.

If the investment product offered is an insurance product, such as a variable annuities or variable life insurance policies, then Mr. Campbell is licensed to conduct variable annuity and insurance business in California, Florida, Washington and Wyoming under his life and annuity license numbers 0775396, W037749, 783455 and 194242.

Disclaimer: The opinions and forecasts expressed are those of the author, and may not actually come to pass. This information is subject to change at any time, based on market and other conditions and should not be construed as investment advice or a recommendation of any specific security or investment strategy. Please consult us or your financial advisor regarding your specific situation prior to implementing an investment plan. Past performance does not guarantee future results. Investing involves risk, including loss of principal. When redeemed, an investment may be worth less or more than the original investment amount.

Reproduction or distribution of this material is prohibited and all rights are reserved. Certain material in this work is proprietary to and copyrighted by Litman/Gregory Analytics and is used by Opis Advisors, Inc. with permission. Reproduction or distribution of this material is prohibited and all rights are reserved. Securities America and Opis Advisors Inc. are not affiliated with Litman/Gregory Analytics. The opinions expressed are those of Litman/Gregory and not necessarily those of Securities America representatives. Securities America does not conduct research or make a market in any securities.