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SUMMARY ECONOMIC FORECASTS FOR 2012

Another Year of Living Dangerously

- **US --- Economy will slow markedly in the first two quarters as consumers and companies cut back on spending. Growth should pick up in the second half with an improvement in economic fundamentals and less political uncertainty.**

- **EUROPE --- Recession is certain. ECB to lower benchmark rate to record low. Greece expected to leave the single currency group by year-end. Odds are even Portugal and Spain will follow.**

- **CHINA --- China's economy will cool early in 2012, but the government is prepared to act quickly to prevent a more serious slowdown. Growth to rebound later this year.**

- **OIL --- Oil prices to hover between $100 to $135 a bbl. (WTI) as geopolitical tensions climb in the major oil producing regions. The tightening economic noose around Iran will likely lead to clashes with US naval forces in the Persian Gulf.**

- **MIDDLE EAST --- Violence in Syria could embroil Lebanon; Iran's growing influence in Iraq poses new risks for Saudi Arabia and Jordan.**

United States

GDP Growth (%):
2012 = 2.0
2013 = 3.1

The US economy ended 2011 on a bright note after growing an estimated 3% in the final quarter, easily the best performance of the year. Better employment numbers and pent-up demand helped spur consumer spending. Greater business outlays and exports also boosted economic activity.

Does this mean the economy and the job market finally turned the corner?

We wish that was the case, but our analysis indicates otherwise. **The rebound in the fourth quarter is not expected to continue the first half of this year.** These temporary bursts of economic activity have become more commonplace lately. Back in 2009, Federal Reserve Chief Ben Bernanke spoke of "green shoots" sprouting up in the economy, raising hopes of more vibrant growth. But those shoots quickly withered. Recall, too, how the economy entered 2011 with lots of momentum, only to see it sputter out as the year progressed. This pattern is likely to be repeated early in 2012, with the economy losing steam in the first months of the new year, though we do see it gain more speed in the second half. Overall, GDP will expand by 2.0% in 2012, slightly better than the 1.6% pace seen last year, and then increase a more solid 3.1% in 2013.

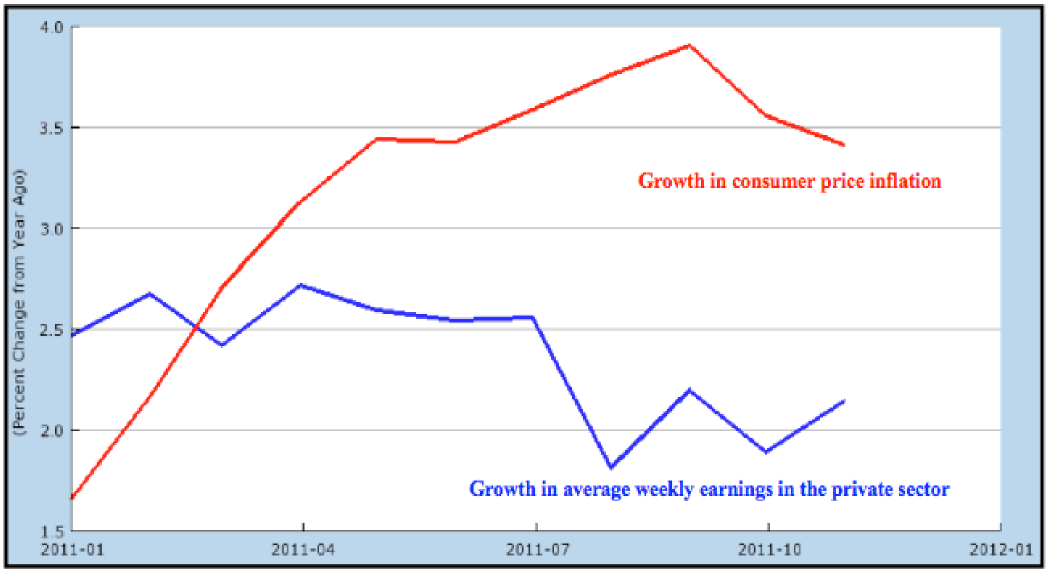
Why another lackluster performance this year?

- **Expect a cutback in consumer expenditures.**

Americans have kept a tight leash on spending the last three years and this frugality increased pent-up demand for autos, home appliances and electronics. So much so, that consumers could not remain idle much longer. They were clearly looking for a reason to ramp up shopping and they got it in the final quarter as labor market conditions slightly improved and retailers posted big holiday sales. We anticipated this sharp upturn in consumer spending in our November 15th *Economic Talking Points.*

But the recent uptick in shopping, while cathartic, is simply unsustainable. To begin with, wages have consistently failed to keep up with the cost of living. Average weekly pay has trailed inflation all of last year (Chart 1). This persistent **erosion in household purchasing power** meant that for consumers to increase spending, they had to close the gap between lagging wages and the rising cost of goods and services. That gap was bridged when Americans resorted to borrowing more and shunning savings. Both credit card debt and personal loans increased toward the end of the year, according to Federal Reserve. Consumer installment debt in October (most recent available) climbed to its highest level in more than two years, and the personal savings rate plummeted in five months from 5.0% to 3.5%, the lowest in four years.

Chart 1: Wages have consistently failed to keep pace with the cost of living

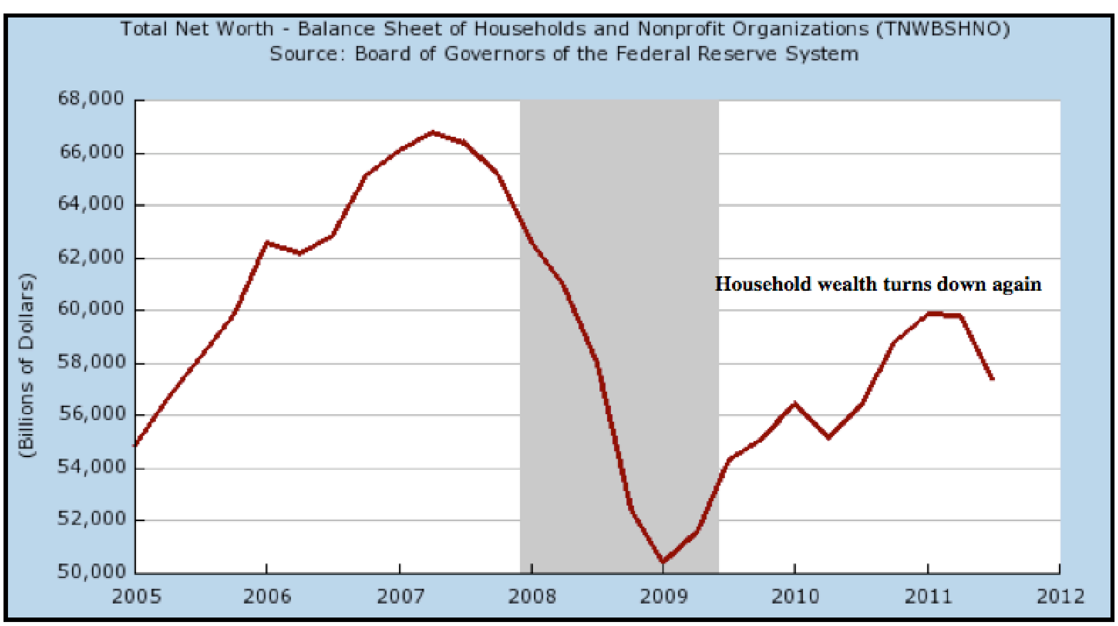


Source: Federal Reserve Board

By depending more on debt and savings, Americans were able to boost spending about 2.8% in the final quarter, the highest of the year. **That certainly provided a nice jolt of stimulus to the economy, but the increasing reliance on new debt and savings to finance consumption is hardly a suitable foundation for future expenditures.** As bills come due early this year, we expect to see households retreat from spending as they resurrect their balance sheets and replenish savings.

Another factor that will depress spending is the **decline in household wealth**. The deterioration in the stock market and home prices slashed the net worth of Americans by another $2.4 trillion in the third quarter (see Chart 2), a loss that amounts to $7,800 for every man, woman and child in this country. Imagine, here we are more than 2½ years into the recovery, yet households have only been able to recoup about half of the $16.4 trillion in wealth lost from the 2008 – 2009 recession.

Chart 2



It is true, we recently saw some positive numbers on the **jobs front** and that is encouraging. But let's keep this improvement in perspective. Since July, one out of three positions filled were in the temporary workforce or in retail sales, both quite volatile sectors. Secondly, the pace of hiring will remain subdued because employers still lack clarity on where the economy is headed.

Our forecast has total nonfarm payrolls growing an average of 150,000 a month in 2012, which is better than last year's 130,000 pace, but it still remains far short of the 300,000 monthly average needed to bring the unemployment rate comfortably below 8%. To reach a 300,000 pace, however, the economy has to grow better than 3.5% a year --- not the tepid 2% rate we expect in 2012. As a result, we see unemployment backing up to 9% by mid-year, before slipping toward 8.3% year-end. This upward bounce in the jobless rate will also weaken consumer confidence and clip spending in the first half.

One other critical assumption behind our forecast for household spending is that **energy prices** will rise this year. It is noteworthy that crude has hovered around $100 a bbl. in recent months --- ***even*** with a dormant European economy, a slowdown in China, and modest growth in the US. The main reason oil prices remain so elevated is that traders have permanently embedded an extra $10 to $20 premium to the price of crude in anticipation of a confrontation with Iran. With the economic noose tightening around that country, there's a very high probability the regime will lash out and seek to disrupt oil flows in the Persian Gulf this year. (See more of this assessment in next section below.)

We thus expect WTI **oil to settle in the range of $100 to $135** a barrel during most of 2012, though it could easily spike higher should a more serious clash erupt between US and Iranian naval forces. With crude sticking above $100 a barrel, gasoline prices will rise to $5 a gallon by spring, and that ultimately would force many consumers to cut back on other kinds of spending.

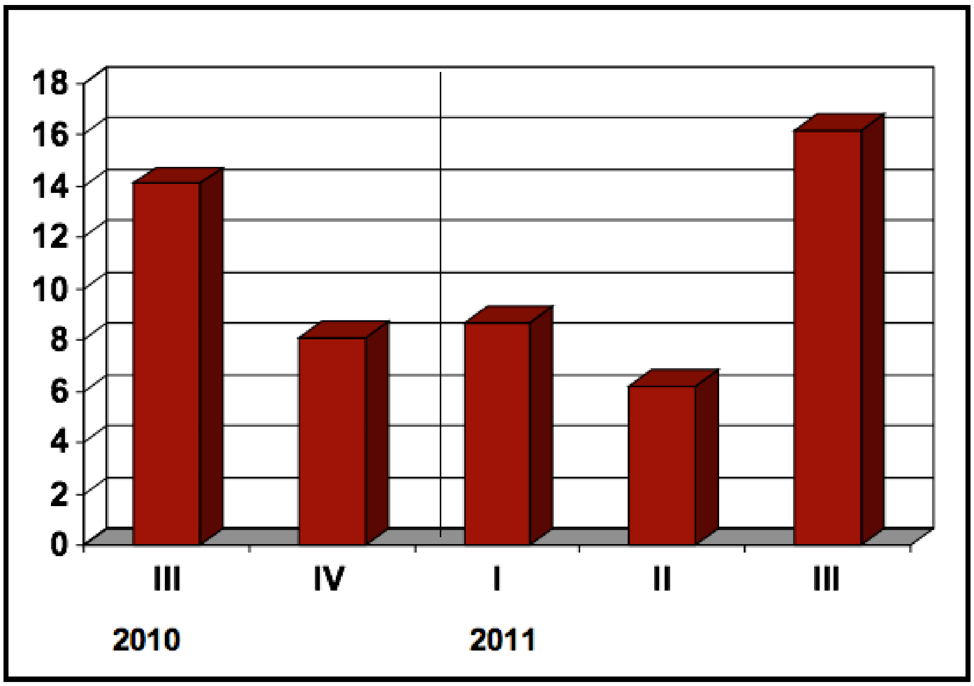
Nor will **the latest legislative bromide from Congress to extend the payroll tax holiday** and **unemployment benefits another two months** do much to encourage more spending. Even if Washington ultimately stretches both programs to the full year, it will only have a marginal impact on the macroeconomy. We estimate the extra cash households receive will largely (80%) be either saved, used to pay off existing debt, or help offset higher fuel costs in 2012. At most it would add about a 0.5 percentage point to GDP growth this year. If Congress, however, fails to extend them beyond the first two months, it can subtract growth by as much as 1% since the decline in take home pay will force Americans to use more of their shrinking real income to cover higher fuel costs and debt payments.

The point here is that with the economy barely clinging to 2% growth, any loss in domestic demand this year pushes the country closer to the precipice of recession, hardly the place you want to be given the high risk of new shocks from Europe and the Middle East in 2012.

- **Business to pull back on capital investments**

Corporate spending has been an important contributor to GDP growth in 2011. **Investments in computers, software and machinery** increased solidly every quarter as firms looked to improve operating efficiencies and raise the productivity of their employees (Chart 3). In addition, many firms have forged ahead to invest in capital, rather than on labor (as in hiring), to control future health care costs and cover their pension liabilities.

Chart 3: % Change, quarterly (SAAR): Real corporate spending on equipment and software



Source: BEA

A lot of these corporate investments, however were bunched up toward the back half of 2011 before the **expiration of the federal tax bonus**, which allowed firms to write off 100% of purchases made and put in place last year. This depreciation allowance will drop to 50% in 2012. The rush to accelerate capital spending in 2011 will probably depress new investments the first half of this year.

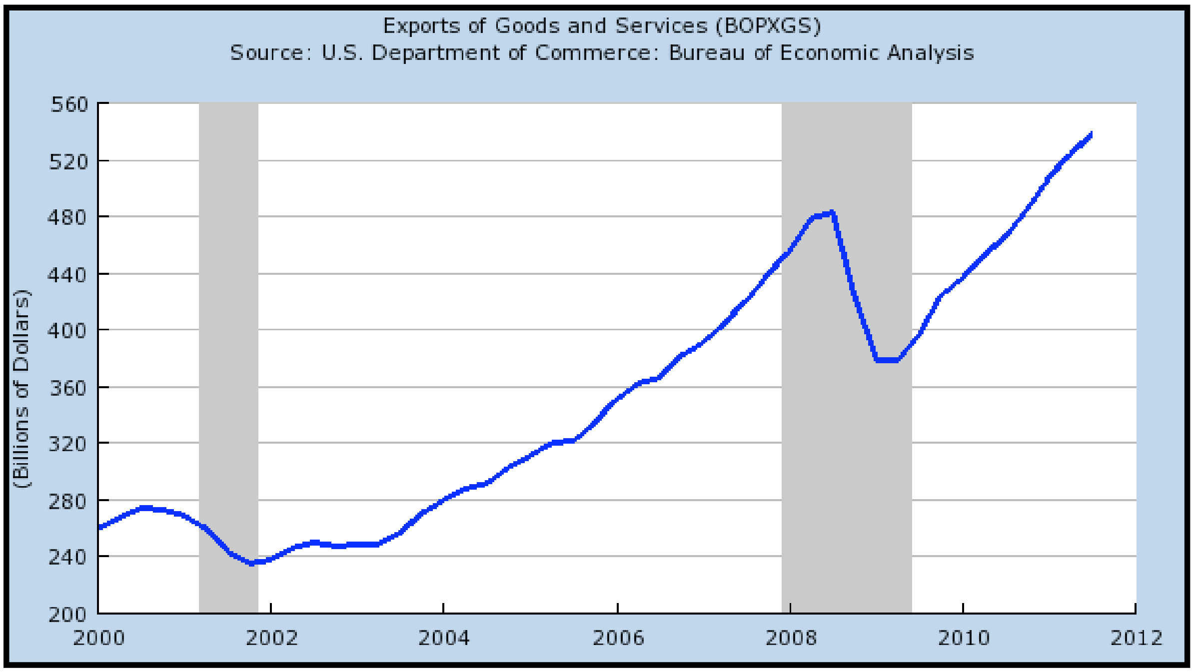
A third factor that will curb business outlays is the pervasive **uncertainty about the economic and political outlook.** Among the many questions that interfere with investment and hiring plans are these: Is a European sovereign debt default likely, and how badly can that damage the US economy? Will the US presidential election finally end the deep political divide that has paralyzed Washington? What's the outlook for government spending, tax and regulatory policies? Will the rating agencies issue further downgrades on US public and corporate debt and how will that affect the cost of capital?

Given these lingering issues, it is understandable why nonfinancial firms are perfectly content to sit on a record $2.11trillion in cash reserves and liquid assets.

- **Exports to stay strong**

This is not to say American industry will be idle. US manufacturers will remain busy this year for two reasons. First, inventories at wholesalers, manufacturers and retailers remain relatively lean, which means any pick up in demand (from domestic or foreign sources) will quickly lead to new orders and more production. Second, growth in the emerging countries should also keep **US exporters** busy. While business activity in Asia and Latin America will ease, their economies are expected to be robust enough to buoy US exports (Chart 4). Keep in mind that in the last 20 years, there have been more than 2 billion new workers in the emerging countries. This new consumer class will be a vital source of demand for US consumer and capital goods.

Chart 4.



Our forecast is for export growth to slow to 12% in 2012, compared to 15% last year, with shipments to Europe accounting for most of the decline. We expect the **dollar to strengthen** against the euro and yen (to 1.25€ and 83¥,) in the first half of the year as global investors continue to flee to the US for safety. **But the greenback will lose ground in the second half,** after investors grow more comfortable with Europe's outlook and as energy prices come off their peaks. The dollar will drop to 1.39€ and 79¥ at the end of 2012.

- **Housing - Some sunlight breaks through**

Housing will be one of the few bright spots in 2012. Demand for rental apartments has been surging in the aftermath of the property crash and mortgage meltdown. Sales have also picked up for both new and existing single-family houses at the end of last year, a noteworthy trend since winter is typically a slow period. Pending home sales, which is based on contract signing, surged in November to its highest in 19 months. Moreover, buyer traffic into homebuilder showrooms jumped in December to the most in 3½ years.

We no longer see housing as a drag on the economy in 2012. Housing starts, which had been stuck at 60-year lows, should jump by 20% this year, to 725,000, the most since 2008.

- **Inflation**

US consumer price inflation climbed most of the year, before leveling off in the final months of 2011. The rise in the cost of living peaked at 3.9% in September (year over year), and then slipped to 3.4% in November.

Will prices continue their recent downward trend in 2012?

No. The main reason for CPI's retreat the end of last year was the temporary drop in energy prices. Prices on virtually every other product continued to escalate to year highs (including food and beverages, housing, apparel, and medical care). In fact, core CPI did not miss a beat rising all year, with the November annual rate at 2.2%, the most in more than three years!

Headline inflation will accelerate to the 5% range this year. Higher fuel costs, faster US growth in the second half, and a more resilient Chinese economy will prod consumer prices higher.

The International Economy

Europe

GDP Growth (%):
2012 = -2.0
2013 = 1.5

The 60-year long progression toward European economic integration, a bumpy process from the very beginning, has come to an end for now as the region struggles to solve a potentially ruinous sovereign debt crisis. In the last two years, politicians have brainstormed through 15 summits and crafted 5 major agreements to fix the mess. While the latest blueprint in December was the most ambitious yet to end the crisis and prevent contagion, there is still much discord over its provisions.

Worse yet, investors in the financial markets continue to be dismissive of the remedies proposed. And who can blame them? To confine 17 sovereign nations with disparate national economies to one currency, a single interest rate policy, and now demand they also surrender some sovereignty over their own domestic fiscal policy --- may be politically unviable.

In many respects, the current debt crisis was inexorable. The little hairline cracks in the eurozone's original architecture --- gaps many of Europe's leaders overlooked or dismissed 12 years ago --- have now swelled into faults so massive they cannot be fixed within the current legal framework.

Nor will it be easy for Europe to proceed with historic reforms at a time when the region is so economically weak. Calls for austerity could not come at a worse time. Much of Europe is now in recession, burdened by high debt, an undercapitalized banking system, and growing public unrest. Little wonder investors continue to flee the government debt market. They have not yet seen a credible, comprehensive and workable plan to address the problem. So what is left is the disturbing image of the eurozone in the form of a wobbly drunk on the top of the hill; you know he's going to fall, but not precisely when or how hard.

What's behind this investor skepticism?

--- Neither the European Financial Stability Facility (EFSF) nor the European Stability Mechanism (ESM) have the resources to adequately solve the problem given the money Italy, Greece, Spain, Portugal, and Ireland need to raise this year to replace maturing debt and raise new funds.

--- It does not appear the IMF will have enough funds to deal with the sovereign debt crisis, even if Europe's central banks contribute 200 billion euros to the organization.

--- The European Central Bank (ECB) has so far refused to act as lender of last resort in this crisis. Unlike the Federal Reserve and the Bank of England, the ECB is prohibited (under Article 123 of the Treaty of Lisbon 2007) from using its balance sheets to engage in a form of quantitative easing that directly funds governments in an emergency. Nor is it even lobbying for a change to allow such an option.

--- While the ECB has permitted European banks to borrow as much as they need, there are no signs lenders will roll those funds out to finance private sector activity, or to prop up the eurozone sovereign debt market. After all, the banks have worries of their own. Nearly 300 billion euros of their bonds mature in the first quarter, and three-quarters of a trillion euros for the year as a whole.

--- What's more, the December meeting in Europe has called on the 26 EU countries (Britain has bowed out) to do something the group has historically proven incapable of doing, which is to rapidly pass truly fundamental reforms. For instance, the new European Union treaty is to be signed and ratified by March and go into effect once approved by nine of the 17 countries in the eurozone. (The remaining countries in the European Union will join once they ratify it.)

That is a tall order. Typically it takes years for such consequential changes to be passed by governments. Remember, this treaty seeks to codify balanced budget amendments, impose automatic penalties if deficits and debts violate limits, and requires countries to submit borrowing plans to a transnational European body for review.

How likely is it they will march in lockstep and pass such a substantive treaty within months? To help answer that question, we turn to an earlier challenge Europe faced when a pitch battle erupted in the 1970s over the term "chocolate." Belgium and other purists insisted that candy made only with pure cocoa butter must be designated as chocolate. Not so fast, argued Britain and a few other countries. They refused to restrict the definition and demanded the right to call their own products chocolate even if made with non-cocoa fats. Lawsuits were filed. Politicians jumped into the fray. The confectionaries would not budge. It took ***nearly 30 years*** for the brawl over chocolate to end. In 2000, the purists finally giving in.

A healthy doze of skepticism is thus warranted that Europe will move with light speed on this treaty. Yet to allow the crisis to fester another year, greatly increases the risk of a more violent collapse of the eurozone, where contagion could spread and possibly trigger another global financial meltdown.

Nor do we believe this treaty, even if signed, will be sufficient to calm capital markets. Europe's leaders have to act more boldly.

Big changes to come to Europe in 2012

After dithering for two years, Europe will have to tackle the issue head on, and that means addressing the primordial question: **What will it take for investors to feel more comfortable *buying and holding* European sovereign paper AND bank debt?**

Here's what we expect to see by the end of the year:

(1) Greece will be out of the eurozone. The risk of a disorderly default and contagion is too great. The country is about to enter its fifth consecutive year of recession with debt ballooning to nearly twice the size of its GDP. To prevent a sovereign debt collapse that triggers bank runs and capital flight, Greece would have to exit the eurozone this year. There is a better than even chance Portugal and Spain will follow.

We do not believe these three countries can recover from their debt crisis in less than a decade if they remain in the euro currency system. By returning to a separate, cheaper currency, they will become more trade competitive, see export earnings climb, attract tourism, improve employment and re-energize their economies. These nations must still implement structural reforms if they are to rejoin the eurozone in the future, but these reforms will be a lot easier to carry out once their economies and jobs are growing.

What signs are there the eurozone is moving in this direction? In recent weeks the political dialogue has undergone a subtle shift. The narrative out of Germany and France is to give the highest priority to protecting the integrity of the single currency system ---- not explicitly the preservation of a 17-country eurozone. We believe this is an important distinction that sets the stage for the departure of the most financially troubled countries.

(2) We also expect that Germany will cross the Rubicon by year's end and allow for a modification in the ECB's statues that will permit the central bank to act as a lender of last resort to governments during times of financial systemic risk. Germany is increasingly being isolated by its hard line position against any change in the ECB's role. Austria, France and the Netherlands appear more willing to assign a greater role for the single central bank.

(3) In terms of monetary policy, the ECB will lower rates to a record low 50 basis point this year to combat the recession.

(4) European banks will beef up capital by raising more than 200 billion euros to better absorb loan losses from the recession and more accurately reflect the value their sovereign debt holdings.

Again, the reason we view European leaders heading in this direction is the lack of a credible alternative. To prevent a calamity, Europe has to lay the groundwork that makes investing in sovereign and bank debt compelling again. And that means a smaller eurozone, a central bank with broader powers, lower interest rates, and a better capitalized banking system.

China

GDP Growth (%):
2012 = 8.3
2013 = 9.0

China's economy slowed last year after policymakers repeatedly tapped on the monetary brakes and curbed bank lending to cool inflation and prevent excessive speculation in the property market. They have succeeded in both objectives. Beijing's big worry now is to avoid a more precipitous decline in economic activity, one that can worsen unemployment and provoke social unrest.

Its GDP expanded about 9.2% in 2011, but is now in the process of slipping below 8%, the minimum speed needed to prevent a significant rise in joblessness. Remember, China needs to create more than 12 million new jobs each year just to keep their urban unemployment rate from rising. (In contrast, the US has to produce about 2 million new jobs to do the same.)

Our forecast calls for growth in China to decline to a 7.5% pace in the first half, but then return toward 9% in the second half as policymakers rapidly shift priorities from fighting inflation to facilitating faster growth. Among the stimulative measures we expect to see in the first six months are lower reserve requirements for banks (a process that started in December), a decline in interest rates, and slower appreciation of the renminbi.

If there is one consistent policy response we have seen with China over the years it is how quickly the government acts to safeguard the country from global economic storms. Policymakers have been able to adroitly steer their economy away from problems that have afflicted most other nations (e.g., China dodged the 1998 Asian financial crisis, the Russian debt default, the dot.com bust, and 2008 - 2009 Great Recession which engulfed virtually every other major economy).

That is not to say China is home free this time. Far from it. A more serious collapse in Europe or a disruption in oil supplies from the Persian Gulf can pose huge challenges. The latter risk is particularly serious. Oil is the weakest link in China's economy. Despite years of aggressively working to diversify its petroleum sources around the world, China still looks to the Middle East for about half its oil needs. Moreover, China's own strategic petroleum reserve remains deficient. It is estimated to have anywhere from 15 to 35 days worth of emergency supplies, far below the 90 days held in the West. Beijing is now rushing to fill its reserves (perhaps in anticipation of a US – Iran clash in the Persian Gulf) by accelerating oil purchases from Saudi Arabia.

In the midst of all this, China is also preparing hand over power to new leaders this year, a process that adds an element of uncertainty in terms of future economic and foreign policies. President Hu Jintao and the Prime Minister Wen Jiabao will relinquish their roles to Xi Jinping and Li Keqiang, respectively. We know little about these figures, but word has filtered out that they will be more nationalistic, push for a dominant Chinese naval presence in the western Pacific, and show more clout on the world political stage.

Of more immediate concern to policymakers is how to carry out the delicate balancing act of fostering stronger growth, without reheating inflation or touching off another round of speculation in real estate. Their other urgent objective is to secure an adequate supply of oil in the event of a disruption in supplies form the Middle East.

Russia

GDP Growth (%):
2012 = 3.0
2013 = 3.7

This will be a tough year for Russia on several levels. First, growth will slow to 3% in 2012, a percentage point less than 2011. What makes even this performance so tenuous is the country's link to Europe. The European Union accounts for 50% of its exports so a deeper or prolonged recession in Europe could produce a hard landing for Russia as well.

There is another reason to suspect trouble ahead. The sight of Vladimir Putin elbowing his way back into the presidency has many Russians upset and raises fresh concerns that further progress to open up the economy will be resisted. He has scorned economic liberalization in the past and stifled dissent. Unlike Medvedev, who is seen as more moderate and approachable, Putin conjures up an image of a leader that is a throwback to the days of the Soviet Union, an autocrat who tolerates cronyism and distrusts real democracy.

The nightmare scenario for investors is the combination of a Putin Presidency that lacks legitimacy, a boisterous citizenry that takes to the streets, an economic collapse of the eurozone, and a deterioration in relations with the US over a missile defense system in Europe. This is an ugly brew that has investors so worried, it already sparked capital flight out of the country in recent months. Even US and European banks are cutting their exposure to Russia.

Moscow will thus have to confront several challenges in 2012, economically and politically. We believe the risks for Russia are mostly on the downside this year.

Geopolitical Risks in 2012

Rarely in world history have we seen the kind of geopolitical upheaval as those that swept across North Africa, the Middle East and Asia last year. This maelstrom is certain to continue through 2012. Indeed it may take a generation or two before we know how it will all play out. In the meantime, these events already raise a profusion of questions on how they will affect regional stability, oil prices and foreign policy

- Will Egypt's ruling military council cede power to an Islamist government?
- Is the brutal Assad regime in Syria about to fall?
- Will the violence in Syria spill into Lebanon?
- Will the departure of US forces from Iraq turn that country into a satellite of Iran and endanger the stability of neighboring Saudi Arabia and Jordan?
- Is Pakistan about to plunge into anarchy and place its nuclear weapons at risk?
- How will an inexperienced 27-year old rule a nuclear-armed North Korea

It is clear this will be another year of intense geopolitical uncertainty. There is, however, one country that poses the largest threat to stability and the world economy as we begin the new year, Iran.

Iran

The confrontation over Iran's secret nuclear military program has entered a more dangerous phase now that the odds have increased of a clash between US and Iranian forces in the Persian Gulf. The fallout could push oil prices sharply higher and endanger global economic growth.

Why is the conflict with Iran culminating at this time?

Iran has shown absolutely no sign of backing away from its secret pursuit of developing nuclear weapons. Most analysts believe it will cross that threshold within the next 12 to 24 months. The abject failure of diplomacy to dissuade Iran from its nuclear path has ratcheted up warnings by Israel that it will take military action to block the regime from achieving its goal. If, in the end, Iran still succeeds and develops a nuclear weapon, Saudi Arabia, Egypt and other nations in the region warned they would then seek their own nuclear arsenal.

Thus, Iran's undertaking will either trigger a dangerous war with Israel -- or -- result in the proliferation of nuclear bombs throughout the Middle East, an apocalyptic vision of its own.

To thwart Iran from its nuclear objective, the US and other nations have ramped up economic pressure against that country. Last November's report by the International Atomic Energy Agency, which concluded that "*Iran has carried out activities relevant to the development of a nuclear explosive device*," provides the international legal cover to tighten the noose around Teheran. Some countries have gone so far as to carry out a covert war inside Iran by targeting its principal nuclear and military assets.

This multi-faceted assault on Iran (using economic penalties, launching computer viruses, on the ground sabotage and assassinations) is based on the belief the Islamic regime will not be able to withstand this punishment much longer. If true, we are approaching a decisive stage in this confrontation.

How will Iran respond?

Option one: Iran can choose to capitulate and give up its nuclear military ambition. Just a few days ago, it formally proposed to re-open talks about its nuclear program in Geneva with the group representing six world powers (U.S., Britain, France, Germany, Russia and China). The problem is we have been down this path before. Teheran even repeated in its latest proposal that under no circumstances would it give up the right to enrich uranium, which pretty much makes the point of negotiations moot.

Further undermining any chance for successful talks is that Teheran opened the new year by announcing the production of its first nuclear fuel rod, a big leap forward in the ability to construct nuclear weapons. And if that show of defiance was not enough, Iran also test fired cruise missiles during naval exercises in the Persian Gulf. These actions, along with the regime's theocratic belief it will ultimately prevail over Western ideology and culture, suggest the chance of Iran capitulating over its nuclear program is very slim.

Option two: To counter Western pressure, Iran could call on Hezbollah and Hamas to launch destructive missiles into Israel and trigger a war in Middle East. However, the two terrorist groups may not be so eager to comply. Given Teheran's growing political isolation in the world and the profound changes underway in Syria and Egypt, the leaders of Hamas and Hezbollah may see more wisdom in distancing themselves from Iran and, instead, choose to seek out new strategic alliances in the Middle East.

Option three: We believe the most likely response is for Iran to use the only real leverage it has against the West, oil. The country is the world's fourth largest oil producer and third biggest exporter of crude. Nations that depend heavily on Iranian crude include the European Union, China, Japan, South Korea and India, all major players in the global economy. By ordering its navy and Revolutionary Guard forces to the narrow Strait of Hormuz, where 90% of all Persian Gulf oil exports must pass, Teheran believes it can stir enough trouble to push up WTI oil toward $150 a bbl., with Brent climbing closer to $200 a bbl. Needless to say, the numbers could easily surpass these if the conflict escalates.

What might be the timing for such military actions? Mostly likely it will begin early in the first half when Teheran knows it has the greatest economic and political leverage. It is well aware of the precarious state of the US and European economies. A major oil price shock now could be the fatal blow that tip these economies into a deep recession, and it would happen just when the US, France, South Korea, India, and Russia face presidential elections.

Is there an alternative scenario to consider?

Actually, yes, though its probability remains a low 20%. Iran's theocratic regime could fracture this year. There has been a simmering dispute between President Achmadinejad åand Ayotollah Ali Khamanei, the country's supreme religious leader. It is a feud that is getting nastier by the day. For example, Iran is scheduled to have presidential elections in 2013. But Khamanei may cancel it, since past presidential elections served as a stepping-stone for reformists to enter government and stir trouble for ruling clerics. Khamanei has quietly been pushing Iran's parliament, which he largely controls, to alter the constitution and do away entirely with the post of President, a move that would leave all governing to a conservative-dominated parliament.

Ahmadinejad opposes such constitutional changes and has pushed back in a most unusual way. He has not only fortified his own political base but also took the unusual step in speeches of charging corruption against some of Iran's leaders. Clearly, there appears to be a widening rift between these two top figures. Whether this is the start of a deeper and irreconcilable schism is too early to say, but one should not dismiss the potential for this dispute to splinter the country into multiple factions and perhaps even set the stage for regime change.

Complicating the outlook further is the role of the 120,000-strong Revolutionary Guard. This military and paramilitary group, while still loyal to Ayotollah Khmananei, has also acted more independently lately in part because of the wealth it acquired by taking control of key Iranian companies. It is thus unclear how the RG will respond once the conflict between Ashmadinejad and Khamanei turns more serious.

For now, however, the dominant scenario is that Ahmadinejad and Khamanei will consent to ratchet up tensions in the Gulf by disrupting oil traffic, actions that will raise the stakes on energy prices and expose the economies of the US and Europe to another threat this year.

2012 Global Asset Allocation Model

Last year was an unusual one for the financial markets. Investors had to navigate through a sea of economic and geopolitical minefields, yet the S&P 500 index ended the year right where it began. Other indices were less fortunate. The weak economy and worries about Europe did pull down NASDAQ and the Russell 2000 for the year. It was only the Dow Jones that managed to see a gain (5.5%).

Beating even the Dow, however, was the US government bond market, which returned 9.6%, its best performance since 2008. For that you can thank the Federal Reserve and its pledge to keep interest rates low, as well as the rush into Treasuries by US and foreign investors who were spooked by the European sovereign debt crisis.

Will 2012 be any different in terms of market outcome?

To be sure, the landscape will again be littered with constantly shifting minefields, especially in the early months of the year. That is why we place a priority on preserving capital in the first two quarters. For the year as a whole, we expect stocks to outperform fixed incomes, with most of the gain in equity values occurring in the latter half of 2012.

Based on our macroeconomic forecasts above, our asset allocation strategy in the first half will be different from the second.

US Cash, Cash Equivalents (US Treasuries)

40% 1H - 2012
25% 2H - 2012

In the midst of all the political, economic and financial tumult last year, the one constant has been the perceived safety of US government debt. Not even the loss of its Triple-A rating last summer was enough to change the perception that during periods of grave uncertainty, there is only one reliable place to find protection, the Treasury market.

US government debt will continue to serve as the proverbial mattress for global investors, largely because the supply of risk-free assets in the world keeps shrinking. Rating agencies have downgraded the sovereign debt of several European countries last year and warned of more cuts in 2012. Even countries viewed as economically strong, like Germany and France, will have their creditworthiness questioned.

A second factor that will lure capital to the US is a weaker euro as Europe stumbles on efforts to solve the debt crisis and cope with recession. Moreover, if there is to be a military confrontation with Iran in the first half of the year, it will launch another wave foreign capital to the US and further drive up demand dollars.

Our recommended allocation is 40% in cash, cash equivalents in the first half. That would drop to 25% in the second half as the economic and political outlook begins to improve for the US and European economies, and tensions subside with Iran. In addition, with the presidential campaign coming to a close, there should be greater clarity on future tax and regulatory policies.

US EQUITIES
25% 1H - 2012
35% 2H - 2012

With the US economy to grow a tepid 2% this year, sector selection becomes critical.

Our favorites:

•Integrated oil companies
•Consumer staples
•Consumer companies with global reach, especially in emerging countries.
•High-paying dividend stocks with low payout ratios
•Homebuilders in anticipation of an upturn in sales and construction

•Mid-year shift to consumer cyclicals, technology, and industrials (less consumer staples and dividend-paying stocks).

FOREIGN EQUITIES
20% 1H - 2012
25% 2H - 2012

Our favorites:

Brazil (continued moderate growth; declining interest rates; energy independent; benefits from stimulative policies in China; spotlight intensifies as host to 2014 World Cup and 2016 summer Olympics;.)

Australia (economic exposure to Europe is marginal; healthier banking system; will also benefit from China's loosening monetary policies)

Canada (healthiest financial institutions among the major economies, will gain from rise in oil prices and faster US growth in second half.)

China (will move quickly and successfully to prevent a hard landing)

•Mid-year shift toward European stocks

PRECIOUS METALS

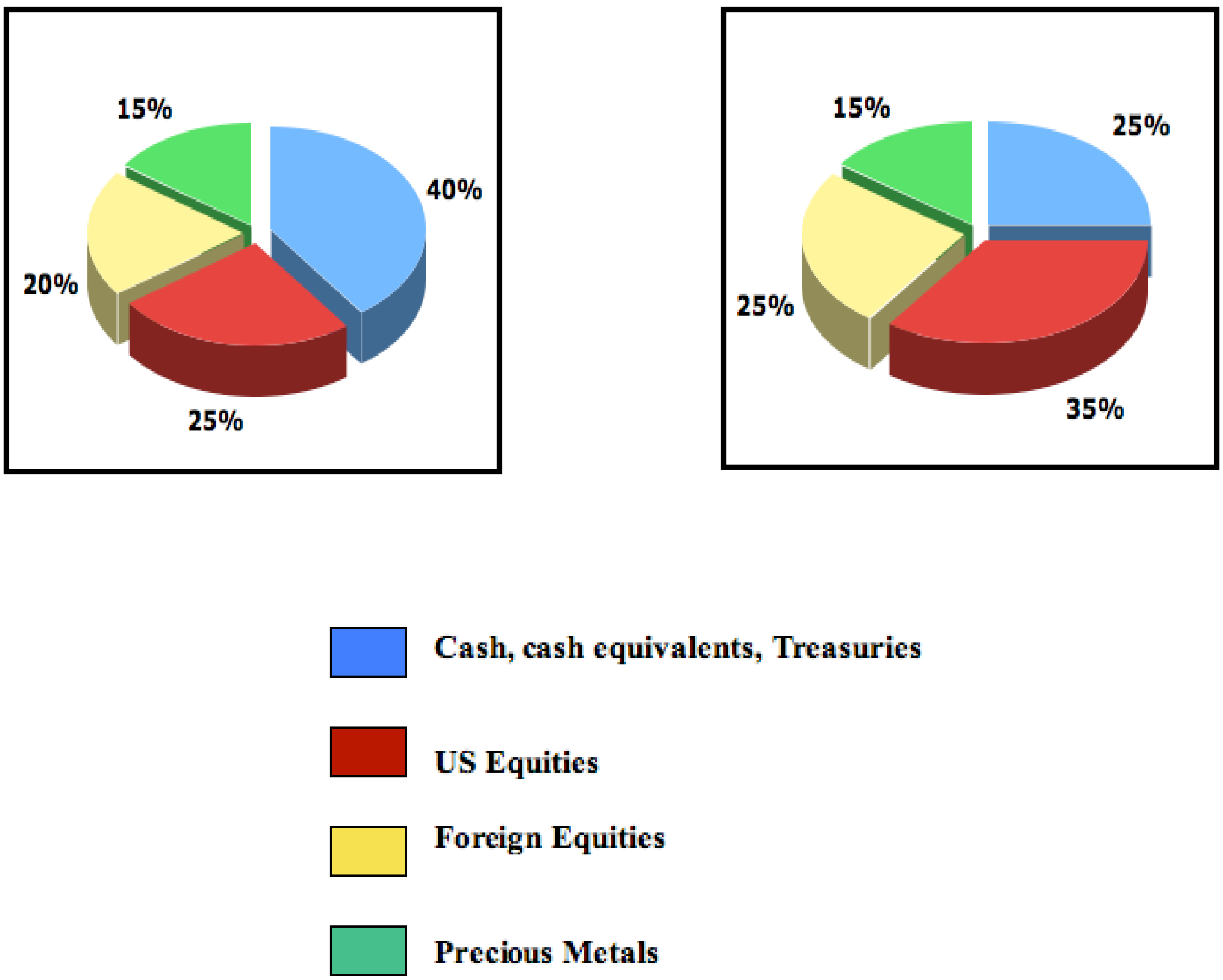
15% 1H - 2012

15% 2H - 2012

Gold will continue to provide comfort against excessive monetary creation in the global economy, sovereign debt worries, and heightened geopolitical tensions. We're projecting gold to climb above $2,300 in the first half, and average $2,100 for the year.

2012 Global Asset Allocation

First Half **Second Half**



Key Economic Forecasts

- Actual
- Forecast

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United States

	I 2011	II 2011	III 2011	IV 2011	I 2012	II 2012	III 2012	IV 2012	I 2013	II 2013	III 2013	IV 2013
Real Gross Domestic Product (GDP):												
%	0.4	1.3	1.8	3.1	0.0	1.8	3.0	3.3	2.6	3.0	3.2	3.6
Personal Consumption Expenditures:												
PCE	2.1	0.7	1.7	2.8	-0.1	1.4	2.7	3.0	2.1	3.2	3.0	3.8
Inflation, end of period, year-over-year:												
CPI %	2.7	3.6	3.9	3.8	3.9	4.5	4.2	4.1	4.0	4.3	4.4	4.1
Unemployment Rate (end of period):												
%	8.8	9.2	9.1	8.8	9.2	9.0	8.8	8.3	8.1	8.0	8.0	7.9
Non-farm Payrolls, monthly avg. thousand:												
	165	97	147	120	95	145	150	220	170	265	280	300
Treasury 10-yr Note Yield % (end of period)												
	3.5	3.1	1.9	1.9	1.7	2.2	2.5	2.7	3.1	3.3	3.5	3.5
Federal funds rate % (end of period)												
	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.75

GDP Growth - Global Economy

Country	2007	2008	2009	2010	2011	2012	2013
US	1.9	-0.3	-3.5	3.0	1.6	2.0	3.1
Eurozone	2.6	0.6	-4.1	1.7	1.4	-2.0	1.5
United Kingdom	3.1	0.6	-4.8	1.4	1.0	0.5	1.8
Japan	2.1	-0.7	-5.1	3.9	-0.3	1.7	2.1
Canada	2.7	0.7	-2.8	3.2	2.2	2.1	3.0
India	8.9	6.1	6.7	8.5	7.2	6.5	8.0
China	14.2	9.6	9.2	10.3	9.2	8.3	9.0
Brazil	5.7	5.1	-0.6	7.5	3.2	4.8	5.3
Mexico	3.3	1.4	-6.6	5.5	4.0	3.6	3.9
Australia	4.0	2.3	1.2	2.8	1.8	2.9	4.0
Russia	8.1	5.6	-7.9	4.0	4.0	3.0	3.7
World	4.9	2.0	-0.6	4.0	2.9	2.6	4.2

Key Currency Values

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013
USD/Yen	91	93	81	77	79	77
Euro/USD	1.40	1.43	1.34	1.29	1.39	1.42

Oil (NYMEX future) & Gasoline (Average retail unleaded, $)

	End 2008	End 2009	End 2010	End 2011	End 2012	End 2013
Crude oil per barrel	43	80	91	99	105	110
Gasoline	1.61	2.57	3.00	3.27	3.50	3.60

Major Stock Indexes

	End 2009	End 2010	End 2011	% Change '11	End 2012	% Change '12
DJIA	10,428	11,577	12,218	5.5	13,314	9.0
S&P 500	1,115	1,258	1,258	0.0	1,397	11.0
NASDAQ	2,269	2,653	2,605	-1.8	2,785	6.9
RUSSELL 2000	625	784	741	-5.5	778	5.0

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