STUART INVESTMENT
MANAGEMENT LIMITED

**Weekly Economic and Market Comment 1-2-2012**

***Happy New Year!***

***The week ahead:*** The more important data releases this week and next are:

- Tuesday, January 3: December manufacturing ISM will be released at 10:00am EST and will likely show a small increase to between 53 and 53.5 from November's 52.7. This number is important because it is the first piece of national data to be released for December.
- Tuesday, January 3: The minutes from the last FOMC meeting will be released at 2:00pm EST. Given the recent transparency and inclination of FOMC members to state their positions, I do not expect the release to have much effect on the market. However, it is important and any information on how the Fed is dealing and cooperating with Europe could be market-moving.
- Thursday, January 5: The non-manufacturing ISM index will be released at 10:00am EST. Although it does not receive the attention of the manufacturing ISM it covers a broader spectrum of the economy. It is expected to mirror the manufacturing index, rising slightly to the 53.4 level plus or minus a few tenths.
- Friday, January 6: The most important (in my opinion) monthly statistic, the employment report will be released at 8:30am EST. The consensus is for another moderate 150,000 rise in payrolls. The unemployment rate which unexpectedly dropped 0.4% to 8.6% in November is likely to tick up a tenth to 8.7%. While there has been improvement in the labor market, November's drop likely overstates the case.

***Looking ahead in 2012***: I will issue my monthly report next Monday. I will outline three scenarios that could unfold in 2012 and give them a likely probability.

- My most optimistic scenario is as follows. The Merkel/Sarkozy to enforce fiscal discipline longer term and the ECB master stroke to allow banks to borrow unlimited funds at 1% which can be used to purchase, among other things, European debt will work as intended. The result would be much lower borrowing rates, especially for Italy and Spain, thus lowering the burden of deficits enough to cause private investors to buy the debt as well, creating a virtuous cycle. At the same time, U.S. lawmakers, seeing how unpopular they are come to their senses and adopt a credible longer-term deficit reduction program while providing a stimulus near term to augment growth. I tentatively give this a 10% probability.

- My base case is that the European and ECB plans work reasonably well, but Greece is forced to leave the Euro, the European recession is long and the Merkel prophecy that the workout will be long and arduous is correct. U.S. lawmakers will make some further limited progress in controlling the deficit and will pass some stimulating "goodies" for the election year, including extending the UI insurance period and the cut in SS payroll taxes for the full year. I give this a 65% probability.
- My pessimistic case is that market forces overcome the European plan and the debt crisis continues leaving Italian and Spanish Sovereign interest rates at too high to allow the debtor nations to avoid a potential default in the future. I give this a 25% chance of occurring.

***The Market:*** If my optimistic case unfolds the S&P would likely test the all-time high testing the 1550-1600 level in 2012. My base case would likely lead to a range a bit higher than last years, say 1150-1400. Despite European problems, continued Asian growth, some limited further profit growth and a small increase in the PE range would allow stock prices to rise moderately. If my pessimistic case unfolds, the S&P would likely drop significantly, and the range would likely be 980-1280.

Near-term, the market is likely to retain recent gains but remain tentative. Merkel and Sarkozy will meet again on January 9, ostensibly to increase the ESFS fund. Prospects for success are supportive. However, following the meeting Spanish and Italian funding in January and February will take center stage. If the funding goes well the S&P should test the 2011 high near 1365 later in the first quarter. Over the next week or two I expect the range to be 1220 to 1280.

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