Clients -

Those of you who review your quarterly reports will notice that much of the downturn in Q3 was reversed in Q4 as markets calmed and fears of a Europe-led global financial meltdown were at least temporarily eased. As we stated in previous updates, as the probability of a European meltdown is reduced, the value of all risk-based assets tends to increase. That certainly held true in Q4.

In my view, the primary reason for this is a new loan facility put in place by the European Central Bank (ECB) by which member banks can borrow money at low rates from the ECB, using virtually any types of assets as collateral, for a term of up to three years. This is a much broader loan program than is typically in place, both in the ECB's acceptance of risky assets as collateral and also in the length of time that the banks can utilize the loans. This facility, known as the Long-Term Refinancing Operation ("LTRO") essentially removes the possibility of a major European bank failure in the next three years because the banks know they can access cheap money from the ECB, even if no one else will lend to them. That in turn instills confidence in the inter-bank lending markets because if no banks are going to go bust, then loaning money to each other at reasonable rates suddenly has little risk associated with it. Additionally, because the ECB is willing to accept risky assets as collateral for the loans, the banks can borrow money cheaply from the ECB and they can purchase the debt of European governments (which have much higher interest rates than the ECB charges, due to the recent increased risk of government defaults). The banks can earn the spread on the interest of the debt they purchase and the low-interest they pay to the ECB to borrow the money used for the purchase. In this sense, the ECB has provided a way for governments like Italy, Spain, and Portugal to borrow money without having to lend large amounts to them directly (which would violate the treaties that created the ECB and the Euro). While the LTRO is a bit of a shell game that moves risky government debt to the balance sheet of the ECB, and therefore to the responsibility of the stronger countries in the Euro-zone like Germany and France, it is much more politically acceptable than Germany and France funding those other nations more directly. So, if we know banks aren't going to fail anytime soon, and we know that European governments aren't going default anytime soon (with the exception of Greece which is too far down that road to help), much of the financial catastrophic risk is off the table for the time being. Don't read this to say that Europe's problems are behind them, but the urgency to resolve them before the financial world ends has eased. That's the primary reason why stock markets are improving, volatility is decreasing (for now), and credit markets are normalizing.

Along with improvements in Europe, the U.S. economy has been showing mild signs of life. Recent economic readings show mild expansion in both the manufacturing and services sectors of the U.S. economy. Jobs are being created (albeit at a slow pace and it should not be forgotten that we're still down six million jobs from the peak in 2007). Housing is showing some signs of stabilizing as the inventory of homes available for sale has fallen to more balanced supply/demand levels over the last few months (though prices and sales are still falling in many areas). It remains to be seen whether this is an emerging trend that instills confidence in consumers and corporations to trigger more spending, more investment, more hiring, higher wages, and the virtuous cycle that follows. I'm skeptical that we can quickly return to the old-normal of 5% unemployment and 3-4% real annual GDP growth while the government is focused on cutting deficits and the consumer is focused on cutting debt and facing higher taxes. But, I do believe there is room for slow to moderate growth through productivity and population growth. There are certainly opportunities for both government and the private sector to be more efficient in our use of resources and in the way we create economic incentives for people to work hard, innovate, and deliver value back to the economy. That efficiency can drive growth for years to come even during an aggregate deleveraging cycle.

Speaking of economic incentives, there are some rather large changes to the tax code that will take effect in 2013 and will have an impact on all of you in their current form. In the coming months, look for a summary from me of what is headed your way from these changes (hint: it's not *lower* taxes). We're in a somewhat strange situation where the changes are already legislated because they come from expiring temporary changes to the tax code. So, the only way to stop them would be to pass new laws that prevent the old laws from returning. Given the political situation in Washington… let's just say that I think it's prudent to plan for higher taxes starting next year and that the higher up you are on the income scale, the more dramatic that increase is likely to be. More to come on that. We'll also be formally kicking off 2011 tax season shortly with a blast message indicating what you need to do if PWA is preparing your taxes this year.

I hope you all had a wonderful holiday, that your 2012 is off to a great start, and that you continue to move closer to achieving all your personal and financial goals. As always, if you have any questions, please feel free to contact me.