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Outlook 2012: Politics and Government Policy Wag the Dog

As if 2011's market volatility hasn't been enough, 2012 promises to be a year where political and government policy headlines will continue to whipsaw investors.

We expect this within our own shores: election-year posturing will bring noise to the news flow; the Federal Reserve will deliberate dramatic new ways to kick a mulish economy up out of the ditch; and a polarized Congress will try fitfully to find common ground where it can get anything done, such that major tax planning efforts will have to stay at low simmer for most of the year.

That last point is vital for our clients. Major estate planning and investment issues hang in the balance. Consider the $5 million individual lifetime exemption amount for gifts – will it sunset as planned at the end of 2012, or be extended, or be repealed early as a Federal budget deficit band-aid? And wheat of estate tax rates – will they revert to prior, higher levels, or will new levels be set? And how about the sweetheart tax rates on long-term capital gains and qualified dividends that have become an entrenched part of the investing landscape? Sure, they've always been "temporary," but after being in place for the better part of a decade, they've stopped feeling that way. What will their expiry mean for dividend-paying stocks going forward, or for market price levels as the clock ticks out on the chance to take capital gains at lifetime low rates?

Likely, answers to these questions won't come till after Tuesday, November 6, 2012, and ten months is a long stretch for legal, accounting and investment clarity to be kept on hold.

Abroad, Europe will still be in the throes of its identity crisis – in what form can the eurozone survive and prosper? – and having countries yoked by a common monetary policy yet distinct by sovereign fiscal policies will be as much a paradox as ever. We're skeptical that recently announced designs for greater fiscal integration will pass nationalistic muster; for instance, in France, Sarkozy's reelection effort trails a frontrunner who insists he'll renegotiate the very eurozone stabilization terms Sarkozy just consented to. How many nations will balk at toeing the line when it actually comes time?

Meanwhile, just as Europe labors to sustain its grandest-currency-experiment-ever, China will labor to sustain its grandest-command-and-control-mercantilism-experiment-ever. Can Beijing's master planners smoothly wind down dual bubbles in credit and real estate at home while faced with slackening consumer demand abroad, as its two largest export markets Europe and USA teeter near recession?

Lastly, the Middle East will play its accustomed role as geopolitical wildcard, with rocky transitions in the wake of 2011's Arab Spring and Iran's perennially excitable regime both providing flashpoint potential to rattle risk premia in markets worldwide.

So what's an investor to do? Most of all, remember that short-term volatility need only define risk for you if you're in liquidation mode and thus have to be a price-taker – i.e. if psychological or cash flow imperatives force you to sell all or part of your portfolio without regard to what the market's paying. A basic rule: Never put yourself in the position of "having" to sell; if you do, you might have to sell cheap.

Indeed, if you're prepared psychologically and have reserved for future cash needs, the roller coaster ride can be a good one for your portfolio. Volatility can bring opportunity to buy value on the dips and pare exposures on the rallies.

On a longer timeline, the great risk is not volatility – it's overpaying for assets, or over-owning them after their price outstrips their worth. So please, in 2012, focus on the health and quality of the dog, not on how it's being wagged.