As 2012 winds down, the U.S. and financial markets continue to face a barrage of challenges. While this is obvious to anyone within range of any mass media, I'll explain why I think many investors have reason to be more optimistic. But first, let's acknowledge the less encouraging issues before focusing on issues that I believe are more relevant to investors.

Europe continues to struggle to work out a solution to their debt problems. As expected, Greece's problems have bled over into other countries with concerns growing over Italy and Spain's fiscal challenges. Even a recent German bond sale went poorly. Europe will possibly slide into recession over the next couple quarters. About 20% of U.S. exports go to Europe, so the U.S. will notice the decrease, but effects won't be catastrophic. We still believe Europe will develop a workable solution. These problems didn't develop overnight, and they won't be solved immediately either.

Continuing on the theme of struggling government, the congressional debt cutting panel failed to deliver as expected. Markets mostly yawned since investors have largely written off the panel's prospects. But, pressure will escalate next year to avoid automatic cuts that would start Jan. 1, 2013 if an agreement isn't reached. We believe it's likely that the law requiring $1.2 trillion in cuts will eventually be reduced to around $700 billion to allow a larger agreement sometime after the 2012 presidential and congressional elections. A smaller agreement would be easier for both parties to swallow, but still demonstrate enough progress to avoid another debt downgrade.

On top of geopolitical issues, businesses continue to worry about taxes and regulations. Not only does the tidal wave of regulations continue to rise, businesses must cope with ongoing uncertainty regarding future change. Increasing and unclear regulations provide a deadly combination, and corporations are often reacting with very conservative expansion and spending policies.

Unemployment remains high, housing values are still declining, and the Indianapolis Colts still haven't won a game (bad if you're a Colts fan at least). Yet, in spite of these issues, or in some cases, because of them, I believe there are many reasons to be optimistic as an investor. To be clear, I'm not saying that all is, or soon will be, rosy. And, the ongoing issues almost ensure that volatility will remain. Rather, history has shown repeatedly that the best time to invest is when things look bad, not after they've clearly turned for the better.

The economy has become self-medicating and no longer needs outside stimulus. While the economy isn't growing rapidly, it should continue to move forward at around a 2.0 percent annual growth rate or better. Energy prices are down and are likely to stay around $90/barrel for next year. Prices around this number spur ongoing development, but aren't high enough to derail the recovery.

Interest rates remain low helping consumers and corporations. Mortgage rates are low and home affordability levels are well below historical averages. Retail sales are up. Last month was the fifth straight month gains beat economists' expectations. Commercial real estate is benefitting tremendously from cheap capital. Values are down, yields remain solid, but financing costs have plummeted.

The dollar is also down. While poor exchange rates make foreign travel less affordable, they're great for exports. Not surprisingly, manufacturing continues as a primary growth engine in the U.S. That hasn't been the case in at least a generation.

Corporate profits continue at record levels, and firms are awash in cash with over $2 trillion sitting on balance sheets. Corporate leverage is at its lowest level since the early 1950s. Corporations can't keep excess cash on their books indefinitely as it's too expensive when earning less than 0.5%. Usually corporations employ cash first for share buybacks, dividend increases, and mergers and acquisition. If done well, these three all benefit stock performance. Later in the recovery cycle, corporations normally use cash for capital expenditures and hiring. These two are good for the economy. By the time companies hire in large numbers, most indicators have already solidly turned positive leading to higher market values.

Corporate profitability has been helped by a favorable yield curve. This yield curve simply describes the different yields paid by bonds of different maturity durations. Normally, yields go up as holding periods increase. This simple relationship has been an excellent predictor of economic ups and downs for over 200 years. When short term rates are much lower than long term rates, the economy tends to grow, often strongly. When short term rates are higher than long term rates, corporate earnings often decline resulting in economic contraction or recession. The last decade illustrates the pattern.

In the fall of 2000, the yield curve was inverted (short term rates were higher than long term rates) with a slope of -30 bps (0.30 %). As predicted, corporate earnings declined and markets reacted sharply with a nearly 40 percent loss over the next two years. In the summer of 2003, the yield curve was very steep with a highly positive slope of 340 bps predicting an increase in corporate earnings. In 2003, the market was up around 27 percent as earnings jumped. In the fall of 2006, the yield curve again inverted with a slope of -60 bps: It took a while for the inverted yield curve to have an effect, but 2007 saw anemic growth and then 2008 followed with a 37 percent market loss. Since 2009, the yield curve has been highly positive resulting in strong corporate earnings and associated stock market returns. Currently, it's still highly positive at around 210 bps which should continue to produce solid earnings.

Household debt is below historical average and households are sitting on lots of cash with more than $8 trillion sitting in money market accounts. Credit card delinquencies are at a 20-year low, and savings rate are coming off a 20-year high. Overall, consumers have much healthier balance sheets than they've had in a couple decades. Yet consumer angst is high. The middle class is very nervous, and they are the primary spenders in the U.S. As confidence recovers, there's a lot of potential for spending to increase.

Sentiment is also misleading. If we look back, in the early 1990s, two thirds of Americans thought we were on the wrong track. The next decade was fabulous for investors. In 2000, 80% of Americans thought we were on the right track. The following decade was horrible for most individual investors. Today, most Americans think we're on the wrong track. Equity mutual funds have seen more liquidations (by some, but not all definitions) than additions every quarter since 2009 during the greatest bull market any of us have ever experienced. Investors seem to be hurting themselves again.

Unemployment levels seem to provide another example of reverse psychology. Investing during times of high unemployment generally produces good returns. It's not that unemployment helps the market perform. Rather, negative sentiment and pessimism keeps stock market values low resulting in great buying opportunities. When unemployment is greater than 6.6%, stock market investments yield average annual returns of 18%. By the time unemployment falls below 6.6% and most people feel better, the market has usually already risen resulting in annual average returns of 7%.

Lastly, markets anticipate election results. It seems likely that many investors and corporate America will view anticipated changes in Washington favorably. Normally, these beliefs translate into action before results are known. While patterns never exactly repeat, it's highly possible that investors will anticipate a more business friendly government in Washington that will translate into increased growth. Of course, even if all my assumptions prove mostly accurate, the ongoing challenges of global economic and government issues make ongoing volatility highly likely, even if I believe there's a lot of upside.

Daniel Wildermuth and the Kalos Team
CEO/Money Manager