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2012
1st QUARTER

Craig Cairns,
President

The Equity Market

A Smooth Start

By Craig Cairns

Since the start of the New Year, we have witnessed nothing short of a seemingly never-ending equity market rally. However, it seems to mostly reflect a level of investor confidence that we haven't seen in a long time. The VIX, a measure of market volatility sometimes referred to as the fear gauge, has dropped to new lows. This is primarily due to short-term positive economic data combined with undervalued stock prices marking 2012 so far, both at home and abroad. This kind of encouraging data has bolstered the markets, at least in the short-term. We can't deny that it has been a great way to ride out the year's first quarter, although we do worry investor perception may have gotten a bit ahead of reality, as there is still a lot to worry about.

Springing Ahead

It has certainly been a relief to see good performance by the markets week after week. The last week of March marked the 26th consecutive week of stronger US economic data, led by ISI's homebuilders survey, which broke above 50 as of March 28. Since the start of 2012, the S&P is up 11%, and over the past five months, the US stock market has rallied about 28%. It is possible that this extensive equity rally is here to stay for a while, if investors stay optimistic and comfortable with riskier assets and do not scramble to safety. Even looking abroad, the global composite Purchasing Managers Index (PMI), an accepted indicator and forecast of economic sentiment, as a summary of the manufacturing industry, increased over four months from 51% to 53.8% in February. However, the US manufacturing PMI is released April 2, and it will be very important to pay attention to, as manufacturing PMI, historically, has been a good double dip indicator, and we are dealing with a third straight year of legitimate worries of a double dip.

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Vince Russo,
Vice President, Director of Fixed Income Research

The Bond Market

1st Quarter Overview

By Vince Russo

This past quarter saw a fairly substantial rise in longer-term interest rates, especially in the month of March. 10-year Treasury yields began the month just below 2% (1.97% on 2/29/2012), reached a high-point closing yield of 2.38% on March 19, and ended the month at 2.21%. During this rather abrupt move up in interest rates, the market once again sought out riskier asset classes. Equities enjoyed the best quarterly performance in quite some time. Regardless of which index one chooses, the attraction to risk assets is back on[1]. So, it should not be too surprising that the riskiest of bond sectors also outperformed the safer ones. The Intermediate Corporate sector of the Barclays Aggregate index returned approximately 2.75% for the first quarter, while the Intermediate Treasury sector of the index had negative returns for the quarter of approximately 0.5%. The biggest winners in the quarter were in the financial sector and the biggest losers were government bonds of the longest maturities– i.e. more than 20 years.

The increase in interest rates that we've experienced recently is reminiscent of other short intervals since 2008, where longer US Treasury bonds have corrected to reflect improving economic sentiment in the United States and global economies. As recently as last October, the 10-year Treasury yield increased from a yield of 1.76% on October 3 to a high yield of 2.40% on October 27, an increase of approximately 0.65%. Another more notable "spike" in the 10-year Treasury occurred in the 3rd quarter of 2010 and peaked in early February 2011. From October 5 to February 7 the yield increased from 2.47% to 3.63%, an increase of approximately 1.25%.

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[1] Dow Jones Industrial Average gained 8.1%; The Standard and Poor's 500 index rose 12%; and The NASDAQ Composite gained 18.7% in the first quarter, the biggest first quarter percentage gain since 1991. Barron's – Saturday, March 31, 2012.

A Macroeconomic Look:
The Good News and the Not-So-Good News

The recent surge in crude prices will mean much higher prices at the pump than Americans have been used to lately, which could negatively impact consumer confidence and discretionary spending. We are unsure of the effect this will have on the automotive industry and auto sales, in particular, but history unfortunately shows us that over the past 10 years, there has been a severe 50% negative correlation between gas prices and motor vehicle sales, where gas prices go up, and motor vehicle sales go down, according to economist David Rosenberg. However, this is just speculation at this point, because in January and February, auto sales were impressive. In other oil-related news, there is concern surrounding a possible Israel/Iran conflict over Iran's nuclear program. If a military conflict did occur, it would have an enormous impact on the global oil supply, and in turn oil prices, since Iran is such a prominent supplier of crude.

The last week of March witnessed a four-year low for jobless claims, with the four-week moving average for new jobless claims dropping by 3,500 to 365,000. However, as could be concluded from Ben Bernanke's speech at the end of Q1, improved employment and jobs data should not be cause for too much celebration. According to the Federal Reserve Chairman, levels are still not where they need to be to grow our economy, and could be more a reflection of fewer layoffs rather than increased hiring. Although he did not mention any plans for a third round of Quantitative Easing, it is probably safe to say that one could sense his caution about the state of our economy for the near future, and his willingness to step in if need be. This proactive stance by the Fed, as is often the case, acted as a catalyst for high investor confidence in the markets following the announcement.

While there has been a fairly significant improvement in housing in the US for the first time in a long time, it remains a very weak area of our domestic economy. Considering we've just witnessed the warmest February and March in decades, some economists seem cautious to applaud the housing sector's performance too much, with new home sales down 1.6% in March, as cited by ISI. However, for the first time since 2005, homebuilding is expected to contribute to growth and recovery in the housing sector this year. We believe this weak link in the US economy is finally starting to turn around, albeit slowly.

Real consumer spending is contributing largely to poorer than would be expected real GDP for the first quarter at 2.0%, in comparison to an unrevised 3.0% in the fourth quarter of last year.

The Euro Zone and Elsewhere

Although it seemed to have faded into the global backdrop to some degree this quarter, perhaps due to a lack of many developments on the scene for the better or worse, the euro zone is still as worrisome as ever, and we've yet to see the full repercussions of its economic struggles. The European Central Bank continues to expand its balance sheet through its Long Term Refinancing Operations program of lending low cost liquidity, but without yet lending in full swing, it is difficult for the region's banks to truly capitalize on the program.

European leaders have been debating how to approach a firewall, or pool of resources intended to stop the contagion spreading throughout Europe. There has been a lot of pressure on Germany's Chancellor Angela Merkel to contribute to boosting resources, and on March 26 she announced her support for combining the EFSF bailout fund with the European Stability Mechanism (ESM). There has been disagreement among various countries on whether such a move is necessary, given that the crisis has quieted since the ECB's LTRO program announced in December, while others believe the current time is appropriate for that very reason.

There are still many signs of recession from countries such as Italy and Spain, and that is what worries the countries who want a firewall in the event Italy or Spain needs a bailout like Greece. Some of the most debt-ridden countries are organizing plans and strategies for privatization, but many think that Greece is too far gone for such an initiative, after continued failures to meet stated targets, much to the EU and IMF's chagrin. Looking out through the year, EU/IMF estimate that Greece's debt reach 327 billion euros by the end of 2012.

In terms of emerging markets, we are also keeping a close watch on China. Although the country is down off of its highs, it still had a healthy start to the year. It has continued to reign in credit, in accordance with a lower growth rate target of 7.5%. We can imagine seeing exports hurt by weakness in Europe, and this is a likely possibility in the upcoming months. The country should work to increase internal consumption and reach higher quality growth, especially to avoid a bubble forming within China's economy.

Cautious Optimism

The general trend of Q1 seems to be one of optimism, but also caution. There are reasons to be optimistic, but also reasons, we believe, to remain cautious, due to investor perception of the state of the economy that doesn't quite match what, in reality, is still quite fragile. As we wrote in our last update, although the domestic economy is performing at a higher level so far in 2012, when you consider how bad things were in 2008, we are still just working to emerge from the deep hole known as recession. This is certainly not to undermine the hopeful improvement we've seen thus far, but it is to remind our clients that 2012 will likely be a rough year with low points and periods of slow growth, even though it has kicked off with quite a bang.

Nonetheless, rates are a bit higher and some would think that this may be signaling the end of the market's appetite for bonds, or more precisely, the demand for longer-term US Treasuries. However, before we pronounce the "death" of investor demand in Treasuries, we really need to ask ourselves: what has fundamentally changed to precipitate the notion that investors no longer demand the safety of US Treasuries?

There's no question that the Federal Reserve Bank's active purchases of longer-term Treasuries and the uncertainty surrounding a disorderly default of Greek sovereign debt have been key to keeping interest rates low, as investors have sought the safest and most liquid securities in the global market place. However, now that a banking crisis from a worse than expected Greek debt restructuring has been averted (at least in the near-term) in Europe and with better than expected economic data with respect to employment and retail sales here in the United States, the prospects of recessionary pressures have subsided. As a result, expectations for further easing of monetary policy by the Federal Reserve Bank have waned. However, expectations of robust economic growth and the re-acceleration of inflation in the United States are not imminent, in our opinion. The final GDP (Gross Domestic Product) figures for the fourth quarter of 2011 released on March 29 showed an annual growth rate of 3%, which is much better than the 1.8% annualized rate of the third quarter, but not nearly enough to make us change our opinion on the structural economic constraints that will likely limit our economy from performing at full potential[2]. The structural constraints that pose the biggest hurdles for a healthy economy are: the continuing yearly fiscal deficits in excess of 8% of GDP, the resulting increase in our government's debt obligations, and the continued high level of unemployment.

The deficits that we have been experiencing since 2008 are worrisome if we continue to spend more than we pay in taxes. The problem will most likely get worse without the appropriate measures to reduce spending and increase taxes. Unfortunately, the political will to take proactive steps in getting our fiscal imbalances resolved does not appear to be palatable to most of our elected officials. Nevertheless, when we do address these imbalances, either through reduced spending or higher taxes, the resulting effect will lead to less fiscal stimulus, which could lead to lower growth expectations, unless the private sector picks up the slack. Meanwhile, the nation's outstanding debt obligations continue to increase and unless we start producing budgetary surpluses, the debt will not decrease. We will not be generating surpluses in the foreseeable future. So, more and more of our taxes will have to be used to service the debt in the years to come. This will also put constraints on our economy, as the capital used to service the debt could be used alternatively by the private sector to foster growth. Even the government could potentially use this capital more efficiently by promoting programs that create incentives for economic growth, as well as job and wealth creation.

The employment picture has improved over the last year, but is still well below historic norms that typically suggest more sustainable economic growth. In February of 2011, unemployment stood at 9%, and as of this February, it stands at 8.3%[3]. Furthermore, the number of individuals who were underemployed (includes the unemployed and those that are part-time due to economic reasons) was at 15.9% in February 2011, while this past February that number had improved to 14.9%. Arguably, some of the improvement lies in fewer individuals in the work force actively seeking employment. As job seekers become discouraged at finding employment they no longer look for work and are no longer counted in the pool of potential workers. Naturally, if nothing else changed, the unemployment rate would decrease. However, the improvement is real; we are simply unsure if it is enough to get consumers to feel comfortable about spending money. For an economy such as ours, which is driven by consumer spending, it is important to have as many people as possible working and earning.

So, in our opinion, it is premature to get overly excited about this recent increase in interest rates. We acknowledge improvement in the economic data, but we are also leery about the sustainability of these improving conditions for the reasons mentioned above. Furthermore, the European sovereign debt issue is far from over. The problem has not been solved, only remedied in hopes of a more permanent solution that only economic growth can provide. For the southern European nations, economic growth will continue to be hard to achieve without major changes in the competitiveness of their labor forces. As southern Europe continues to adopt austerity measures to rein in fiscal deficits, major EU economies such as Italy and Spain will most likely be in recession during 2012. This will certainly have an effect on the rest of Europe and will, to a lesser degree, have a negative effect on US economic growth if all of Europe shows signs of recession.

Are Dividend Yields and Bond Yields Comparable?

Prior to this past quarter's excellent stock market returns, many analysts were making the case for buying equities because the dividend yields generated greater income than the implied yields to maturity of US Treasuries. While that may have been true (and may still be true for some stocks), it does not take into account the relative market risks associated with owning these very different asset classes. First of all, comparing dividend yields of publicly traded companies with those of corporate bonds would be a more appropriate comparison. Most corporations which pay dividends also issue bonds and have inherent credit risk. The US Treasury does not pay a premium interest rate to compensate holders for credit risk. US Treasuries are considered "riskless" securities (in terms of credit risk). In spite of S&P's downgrade of the US debt obligations from AAA to AA+ (August 2011), the capital markets do not require a yield premium on Treasury securities to compensate for credit risk. Therefore, since comparing dividend yields to corporate bond yields is the more appropriate measure, the case for investing in equities based solely on generating greater income becomes less compelling.

But credit is not the only risk one assumes when buying the stock of a high dividend paying company. In the worst case scenario, when a company defaults, the investor in the company's equity goes to the end of the line with respect to getting paid back. If a corporation goes into bankruptcy and gets liquidated, the shareholder gets paid last if there's anything left. The bondholder will most likely get some of his capital back. Remember the old GM, Lehman Brothers, Fannie Mae, and Freddie Mac, just to name a few? These companies were all good dividend payers and their shareholders were left with virtually nothing after their financial troubles.

[2] Bureau of Economic Analysis, March 29, 2012 news release.

[3] US Bureau of Labor Statistics, March 2012 news release.

One other consideration is that dividends are *not* contractual obligations of the company; while coupon payments on corporate bonds *must* be paid when due in order to avoid a default. Dividends are payable only at the discretion of a company's board of directors. Each quarter the board declares a dividend or not. They can change the amount of the dividend or suspend it. Interest payments (coupon payments) on bonds are not discretionary—they must be paid. So, if you are an investor in equities solely for the current income produced from the dividend, "don't count your chickens before they've hatched." During the financial crisis of 2008, many of the banks had to suspend dividend payments or severely reduce them in order to preserve capital. Eastman Kodak, as another example, also had to suspend its dividend after filing for bankruptcy protection. If one had looked at its dividend yield prior to its most recent financial problems, one would have thought it looked attractive. Now, not only has the investor lost the income stream from the dividend, but has also virtually lost his entire capital investment in the event Eastman Kodak does not emerge from bankruptcy as a viable company.

We can sympathize with investors struggling to generate income in such a low interest rate environment, but we would hope there is a clear understanding that investing in dividend-paying stocks is not a perfect substitute for investing in bonds. There are many reasons to invest in a diversified portfolio of stocks (whether or not they pay a dividend), but investing solely because of the dividend yield should not be the principal reason. We believe that as long as one understands the relative risks, it is ultimately the individual's choice how much risk/reward is appropriate for a balanced approach to investing.

If you have any questions, or would like to discuss these topics further, please do not hesitate to contact your portfolio manager. Happy Spring!

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