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## Central Banks Step Up

*By Craig Cairns*

The third quarter of 2012 has been characterized largely by many of the same issues that have been recurring throughout much of the year. Very little has changed, or at least improved, about the global economic picture and, specifically, the euro zone. The prognosis for the region remains essentially the same, with threats of default from Greece and Spain, and worsening fundamentals throughout the third quarter. However, it seems that the past quarter, the bulk of the news has been about the United States, whether political, fiscal, or economic. As a result, we've seen news and updates about the US act as a main driving force behind perception of economic health this quarter—from which we've seen benefits, the most notable of which has been a strong stock market, as well as some hindrances.

### Quantitative Easing, Open-Ended

Quantitative easing, which we have become rather accustomed to after two rounds of it from the Federal Reserve since the recession, describes the process of the Fed buying up bonds in order to stimulate and grow the economy. Past quantitative easing initiatives have included a ceiling for ending bond buying. For example, QE1 was intended for buying \$600 billion in mortgage-backed securities (MBS), and QE2 was intended for buying \$600 billion in Treasuries.

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## 3rd Quarter Overview

*By Vince Russo*

While interest rates ended the quarter at about the same levels that they began the quarter, there have been a few volatile spurts in between. The 10-yr US Treasury yield was approximately 1.65% at the end of June and as of this writing stands at 1.63%. However, this past quarter has been anything but stable with respect to longer-term interest rates. The chart below shows the daily closing yields for the 10-yr Treasury note over the third quarter. From a low yield of 1.39% on July 24, to a high yield of 1.87% on September 14, with a few peaks and valleys in between, the tenor of the market news had a lot to do with the direction of longer-term rates.

What were the news headlines that were moving markets?—well, a lot of the same issues we have been writing about for over a year (seems more like 3 or 4 years). When markets worry about the European sovereign debt problems, the markets turn their focus on risk and seek the safety of the Treasury market, and prices increase while interest rates decline. When the European Central Bank responds to weakening economic conditions in the euro zone and intervenes in the bond market in support of the most vulnerable countries in the European Union (Greece, Spain, Italy), markets respond by selling the safe investments. As a consequence, US Treasury yields begin increasing to reflect lower prices. This is precisely what happened during most of July and half of August.

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On September 13, the Federal Reserve announced a third round of QE—without a spending cap, or in other words, open-ended quantitative easing (QE). In reality, this essentially means that the Fed is not willing to declare an end to buying bonds, and will do so gradually, until we see a significant improvement in the labor market. The Fed will buy about \$85 billion of long-term securities per month, at least through the end of 2012 (Operation Twist combined with an additional \$40 billion of MBS per month).

We may see a rise in commodity prices as a result of QE, as this was the case following QE1 and QE2. Both times, commodity prices surged roughly 65%, according to ISI on September 16. In addition, QE in the past has been accompanied by S&P rallies.

## The Looming Fiscal Cliff

The current tax cuts, set under President Bush, are set to expire on January 1 of 2013, demanding a new tax deal to be secured by Republicans and Democrats in Congress by that date. Both parties have been working on their own tax bills—Republicans offering an extension of all current Bush-era tax cuts, and Democrats allowing tax rates on income, capital gains, and dividends to rise for earnings over \$250,000, but extending Bush-era tax rates for those earning less than that amount.

While President Obama is pushing for a 39.6% (43.4% including the 3.8% investment tax under Obama's Affordable Care Act) tax rate on dividends and a 30% rate on capital gains, the plan presented by Democrats in the Senate entails keeping the tax rate on dividends and capital gains at 20% (23.8% including the 3.8% aforementioned tax). However, the rest of the Senate Dems' plan is aligned with that of Obama, which includes a rise from a 33% to 36% tax rate on married couples' earnings above \$250,000, and a rise from a 35% to 39.6% tax rate on married couples' earnings above \$390,000.

The question being asked by nearly every onlooker is obvious—Will Congress strike a deal? It's unlikely that a deal will emerge before the November elections, but we are hopeful that members of Congress are aware they can put off this issue for the time being, and still secure a deal come January. Since deficit reduction is the true driving force behind the tax re-haul discussion, we are confident that our congressional leaders will be able to compromise by the start of next year. In terms of what that compromise will look like, stay tuned, and stay tuned through November, because whoever takes the White House in the election will likely have a great bearing on what form the tax compromise will take.

Speaking of taking the White House, according to current polling data, Obama is ahead in the contest. We look forward to the next month, full of more campaigning and debating, during which history has proven to us that much can change—and change, and change, and change again. Unfortunately, even if we do believe that a cut will be made, the very real possibility that Congress does not strike a deal in time has the potential to cripple the markets on a global scale. Domestically, if the Fiscal Cliff were to hit, it has the potential to detract from GDP by 0.5%, throwing the US

into recession. The Fiscal Cliff threat has certainly already been having an impact, as even when equities have been performing well, it is looming uncertainties like the Fiscal Cliff that are keeping investors, and particularly businesses, cautious and skeptical of buying into stocks completely, and instead they are hoarding cash and hesitating to commit to hiring and other forms of spending. This is not good for spending and jobs, not only because businesses are unable to know what taxes will look like next year, but they have to worry about a tax deal even happening at all. Therefore, even the threat of the Fiscal Cliff has the power to impact the markets significantly, but in this way, we do believe it is already priced in to some extent.

## "Euro Zone Economic Outlook Darkens"

...according to the Reuters' article titled as such, from September 27, which points to evidence that euro zone business confidence has fallen to a three year low. Plainly stated, "The euro zone economy stagnated in the first three months of the year and contracted 0.2 percent in the April-June period. Economists expect another contraction in the third quarter," Reuters cited.

Even after moments of stark renewal of confidence, such as the ECB taking a more aggressive stance on bond buying, or essentially any one of the 269 (and counting) stimulative policy initiatives taken in the past 13 months across the globe, reality always sets back in for the failing region, with ever-increasing austerity in several countries. While there have not really been significant events behind increased stagnation this past quarter, the region is simply continuing to slow down due to poor fundamentals, such as worsening numbers of unemployed people in many countries, even Germany, which had proven rather resilient compared to its European counterparts, especially in terms of its labor market. Further, the European Central Bank released disheartening data about large decreases in lending to companies in the private sector. Sentiment among euro zone consumers was also disappointing in August and September, waning in almost all sectors. Essentially, Europe faces continued recession, especially if economists are right in their prediction of the zone's substantially contracting GDP in the third quarter.

## The Forecast

In general, we are still in an extremely low growth environment, both domestically and globally. Current and forecasted US GDP is still below average, and in particular, last quarter's GDP has been revised down. We are still a long way from a full economic recovery. Simply, it will be difficult to have normal rates of growth in our economy when crucial fundamentals like employment and income growth are far from fixed.

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While most of us were just returning from our 4th of July weekend festivities, some of the major central banks around the world were responding to the economic malaise affecting their respective economies. Both the European Central Bank (ECB) and China's Central Bank (CCB) cut their benchmark borrowing rates, while the Bank of England (BOE) increased the size of its asset purchase program, better known to most of us as quantitative easing. By the third week of July, markets were really worried that Spain's problems were so severe that its government would be asking for a bailout, and that it was destined to follow the same troubling path as Greece. Every crisis seems to elicit a central bank response, and this one is not different. By the end of July, the markets were selling the safe assets, and interest rates were on the rise again. On July 26, ECB President, Mario Draghi, signaled to the market his intent: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro." "And believe me, it will be enough." While Mr. Draghi was not speaking in his native Italian language, a translation may still be needed. In other words, the ECB will be preserving the euro by relieving the market pressures on Spanish and Italian bonds, by purchasing more of them and keeping their borrowing costs down.

So, once again, it's RISK ON. The cycle of RISK ON/RISK OFF seems to be getting shorter and shorter. Maybe it's because there have been no real lasting solutions. While the European sovereign debt crisis was being addressed by the ECB, the market was not as focused on the economy here at home. By mid to late August, the markets turned their attention to speculation regarding our own central bank asset purchase programs. There had been some doubt as to whether the Federal Reserve Bank would implement another round of quantitative easing (QE3). It became abundantly clear that they most likely would, based on the release of the monetary policy meeting minutes from July 31 - August 1. The minutes were released on August 22, and they reinforced the speculation that more stimulus would

be needed *soon* unless the economy showed signs of a stronger and more durable pickup. To further reinforce the market expectation of additional Federal Reserve Bank stimulus, the Bank's chairman, Ben Bernanke, speaking at the annual Kansas City Federal Reserve Bank symposium on August 31, said that he could not rule out a third attempt to increase the money supply to stimulate economic growth. It is no coincidence that our chart shows that date as the most recent low yield for the 10-yr Treasury note.

There's a saying traders like to use when referring to market momentum: "Buy the rumor, sell the news." The reversal of momentum for more price appreciation in the 10-yr Treasury coincided with the news that the ECB had announced a plan to buy *unlimited* amounts of government debt issued by the most distressed countries in the euro region. This meant that a breakup of the 17 nation union was less likely, so it was a cue for the markets to sell the safety of Treasury notes for riskier assets once again. The speculation of what actions *our* central bank would take was answered with news that the Federal Reserve Bank unveiled a plan at the September 13 meeting that they, too, are going to purchase more agency mortgage-backed securities. The plan is "open-ended" with no specified end date nor total amount to be purchased. In essence, the Federal Reserve will be buying \$40 billion of mortgage-backed bonds every month until it is confident that it has effected a sustained improvement in employment and economic recovery. They also extended their commitment to keep short-term rates between 0 and .25% until at least mid-2015. Once again, selling the news of that day produced the highest yield for the 10-yr Treasury on September 14. However, as we can see by the graph, yields are falling once again and find themselves at pretty much the same levels as when we started the quarter.

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Knowing the long term prognosis is largely unchanged from quarter to quarter these days, we can talk about our expectations of what we think may come in the ensuing months. For the short-term, we foresee pretty good growth in our domestic economy. Entering the fourth quarter, there are reasons to believe that the 2012 Growth Problem in the US is subsiding. On a philosophical level, the Growth Problem of 2012 has closely resembled the 2010 and 2011 Growth Problems, in that for all three of these years, the first three quarters have been marked by indicators of slow or almost no growth. 2010 and 2011 both saw an end to those problems in their fourth quarters, so there is reason to believe that if 2012 continues to follow the path that 2010 and 2011 took, we will see the problem resolved next quarter. In addition to following this pattern, there are also many important indicators (such as consumer confidence surveys and manufacturing indices) suggesting that the end of the 2012 Growth Problem is near. Stock market rallies and continued strength in housing are also positive factors to consider regarding an emergence from the 2012 Growth Problem.

Housing truly is the linchpin, in the sense that as long as housing stays as positive as it has been, the US Growth Problem is unlikely to become a recession. With QE0E, there is also a chance that one impact of it will be a decrease in mortgage rates, possibly from the current rate of 3.5% to 3.25% (ISI Weekly Report, September 23).

Unfortunately, even with a better short-term environment for the US, we are anticipating poorer short-term forecasts for China and Europe. Whereas previous consensus called for improvement in China to finish this year, economists are now pushing out growth at least into the first quarter of 2013. If the outlook for the euro zone was bad before, it certainly has not improved in any way. We do not have much hope for improvement there in the last quarter of 2012. In fact, we will likely see a worsening recession throughout 2012, and very slow recovery throughout 2013.

## A Proactive Stance

In the environment we currently find ourselves, our job as investment advisors is to use our working economic forecast to constantly assess our strategies—assess opportunities to take advantage of, and assess risks and ways to hedge against them most effectively. We firmly believe that even in low growth and low interest environments, often marked by volatility, there are ways to make money staying in these markets.

With 10-yr Treasury yields falling once again, in spite of all the central bank efforts to stimulate economic growth, it is evident that bond market investors are skeptical about the success of such programs. The efforts of the Federal Reserve Bank, the European Central Bank, the Bank of England, and others to rekindle growth in their respective economies, are masking the lack of political will in each of these economies to address the structural issues that need resolution. The lack of fiscal policies that may be unpopular politically is perpetuating the fog of uncertainty that inhibits capital investment and commitment to future growth prospects. It would appear that the central banks are merely filling a void that should be addressed by fiscal policy. Policies regarding how we tax, spend, and regulate capital *do* matter. It is important that capital markets have a clear sense of stable policy in order for capital to be allocated efficiently. In the case of the European Union, it is a monumental task to get 17 nations to agree on uniform fiscal policies. While the US does not face that same hurdle, we still don't know what the aftermath of the elections will be, and it is abundantly clear that fiscal policies need to be addressed to allow the capital markets to adjust accordingly. Monetary policy cannot do it alone. Without a fiscal plan we can expect more of the same temporary solutions that create the volatility illustrated in our chart above.

## Sector Performance

Overall, the Intermediate Government/Credit Index of the Barclays family of indices returned 1.40% for the quarter and has returned approximately 3.5% year to date. As one would expect, the weakest performing sectors for the quarter were US Treasury related securities. Most returns for the sector showed little or no appreciation. The US Intermediate Treasury subsector was the best performing of the Treasury index with a return of 0.62%. The longer end of the maturity range returned only 0.20%. Keep in mind that the longer end of this sector had appreciated by over 13% in the second quarter of this year. However, there were other sectors of the bond market that performed quite well. Corporate bonds, in general, did very well during the quarter. The best performers were corporate bond sectors of longer maturities. Leading the way were longer investment grade financial institutions with a return of 7.69%. It is obvious that the ECB (European Central Bank) policy of unlimited bond buying of distressed Sovereign debt issues had a lot to do with reducing the risk of a European banking system wide crisis. As mentioned earlier in this article we doubt that this action by the ECB will provide a permanent solution to the Sovereign debt troubles in Europe. However, it did "calm" the market fears that the systemic risk would spread to our own banking system here in the United States.

Going into the fourth quarter, we expect more volatility surrounding the same issues mentioned above. What we still need to contend with is the unforeseen market reaction to the impending tax increases from the end of the Bush-era tax cuts and the spending cuts through "sequestration" that were part of the Budget Control Act of 2011. The Fiscal Cliff has probably not yet been fully priced in by the market, primarily because few believe that both or either of these events will occur. The market is of the opinion that there will be some resolution before the end of the year or before each is scheduled to take effect. We'll have to wait and see how the upcoming election results will affect each of these issues.