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2011
3rd QUARTER

Craig Cairns,
President

The Equity Market

Riding Out the Storm

By Craig Cairns

The finances of the US and most European countries are a mess. Living well beyond our means is catching up with both major geographic sectors concurrently. The "piper" is waiting in the wings and wondering if the collective WE can meet our obligations.

Although the idea of an *eventful* summer may elicit day dreams about good times, sunny days, and fun-filled vacations, the context of the economy brings a very different connotation to the idea of an *eventful* summer. The past summer quarter was filled with event after event, and it seemed the old adage, "no news is good news" never rang truer. Let's take a look at US concerns first.

The Debt Ceiling Debacle

July was marked by nothing short of panic surrounding the debt ceiling debate. Essentially, the rule is that when US debt reaches its set limit, the Treasury cannot issue new debt. Without raising the ceiling, there is a liquidity limit and the possibility that the Treasury will not be able to meet its financial obligations. The debt ceiling has been raised many times historically, but this past July, there was drawn out and heated debate surrounding the issue, mostly between Republicans and Democrats in Congress about the spending cuts that would accompany an increase in the debt ceiling. As a result, a divided government, underwhelming leadership from both sides of the debate, and prospects unfamiliar to our country's fiscal history gave investors reason to worry. Even after coming to a tentative agreement to raise the debt ceiling through 2012, along with about $1 trillion in spending cuts, and managing to avoid technical default just in the nick of time, the US would still face repercussions for its out-of-control spending and lack of political initiative in attacking the issue.

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Vince Russo,
Vice President, Director of Fixed Income Research

The Bond Market

3rd Quarter Overview

By Vince Russo

It has been another strong quarter for bond investment performance. During a period when stocks lost much ground, we once again observed a contrary movement in the price of bonds. Truly, a "flight to safety" was underway. For our clients with a portfolio balanced with both bonds and stocks, the positive return from holding bonds has mitigated some of the pain (temporary, we believe) from stocks.

The Investment Climate

Some of the major events or issues influencing financial markets over the last quarter are not new. The sense that our economy is weak and fragile has been something we have contended with since the financial crisis of 2008. Any "shocks" that reverberate throughout the global economies produce a heightened sensitivity to just how volatile and interconnected the capital markets are.

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AAA to AA+

Such repercussions would come partially in the form of a US Treasury credit downgrade from the highest rating, AAA, to AA+, by Standard & Poor's rating agency on August 5. S&P's decision to deliver this downgrade stemmed from legitimate concerns about the direction adopted by the US government. S&P's message was that the increase in the debt ceiling hasn't been accompanied by enough spending cuts to lower our high debt to GDP ratios, and political figures have been unwilling to take the unpopular or difficult stances needed to address this problem.

Timing is Everything

When it comes to the markets, timing truly is everything. The downgrade came just after one of the worst weeks the markets had seen in a couple of years. August 4 felt like a massacre. The Dow dropped more than 500 points, and only three of the S&P 500 stocks finished up for the day. Investors acted with fear that the US and global economies were headed toward recession. The catalyst for the selling was the report a few days prior of not only weaker than expected consumer spending in June, but an actual drop in consumer spending for the first time in two years. In addition, Purchasing Managers Index (PMI) readings (an accepted indicator of economic sentiment, as a summary of the manufacturing industry) signified almost no growth in manufacturing across the board. Faced with continued high unemployment, low wage growth for those employed, panicked rhetoric on the debt ceiling debate, and waning confidence in the future, consumers reduced spending.

Then, *after* the untimely downgrade, the bleeding continued. Stocks tumbled in reaction to S&P's credit downgrade. While there were several warnings and much talk of the possibility of a downgrade, the markets certainly reacted negatively to the nature and timing of S&P's decision. The drop was so severe, it rivaled some of the worst declines we've seen over several decades and reminded an already skittish market about the crash of 2008.

The European Front

While the US tried to tackle these issues domestically, Europe was fighting its own battles—battles from which, unfortunately, we are by no means removed. With Europe's debt crisis only getting worse, and fears about countries like Greece and Italy not acting up to snuff with austerity demands, Germany and other key leading nations in the zone are having to face what they hoped could be avoided: much more drastic fundamental changes will need to be adopted, or the euro could fail, due to the intertwined nature of the euro zone. Reflecting on what was all too familiar on the home front these past couple of months, inaction and gridlock can be as bad for the markets as poor policy initiatives. Unfortunately, we are seeing firsthand that inaction is politically easier, especially when it comes to reaching agreement among several different nations, and when such robust options as the creation of euro zone bonds are too controversial for many to take.

With the way things are going, it is likely that Greece may default soon. The European Union is doing its best to contain the effects of such a potential default, so as not to overly impact the rest of the euro zone.

Regardless, European banks are already taking a hit. There is mounting concern about a European repeat of the banking crisis that happened in the US. Key European banks are having an increasingly difficult time securing loans, especially when the risky nature of the European crisis prevents entities like those in the United States from lending the banks what they need. It is a Catch 22 of sorts—and one whose outcome, regardless, will not be confined to the zone's borders.

Volatility in the Markets

Throughout the remainder of August and September, the markets have given new meaning to the word volatile. We have watched the markets teeter between highs and lows, good days and bad days. Depending largely on the ever changing consensus about the state of the euro zone, and in particular European banks, United States, Asia, and world indices have either acted with confidence or fallen victim to fear. This is evidence of only one thing for sure: the power of fear, and the deceiving impact it can have.

For instance, without any identifiable reason, the past couple of weeks of September took another beating from the markets. Aside from looming uncertainty from Europe, we attribute much of this fear to a lack of hope or confidence in our own gridlocked government, which has struggled to take the bull by the horns, in terms of improving economic growth. As of September 29, global growth was headed below 2.0%. Moreover, domestically, United States PMI has been approaching an unimpressive 49, and analysts lowered third quarter earnings estimates almost a percentage point in just one week.

There is Hope: Moving into the 4th Quarter

While Europe's problems are not superficial ones, steps are being taken to handle the situation and quell the fear in the markets. There may very well be a bank bailout soon, possibly something similar to a TARP program employed in the US, where the European Central Bank or a similar entity buys the "toxic assets," or sovereign debt, from the banks to help improve their balance sheets. In fact, Germany, arguably the most important country in the zone for getting the ball rolling, just passed a bill for the expansion of a European bailout fund. In general, while it is unclear at this point exactly what measures will be taken, things are undoubtedly looking up for the euro zone.

We can also look for hope in the Chinese economy, which is now a major driver of the larger global economy. To prevent inflation, China has held its interest rates high, which has acted as a drag on its markets.

However, Chinese rates and inflation are starting to fall in line with what its central bank believes to be healthy. With this in mind, it is probable that the Chinese central bank will begin to loosen its monetary policy, which will in turn act as a catalyst for new economic growth.

Back home, the Federal Reserve has announced its latest plan to stimulate the economy: Operation Twist. Totaling $400 billion, the plan involves selling short-term Treasuries in exchange for longer-term bonds. The underlying goal is to drive down all types of interest rates, and therefore increase consumer and corporate spending. Although quite controversial in terms of its effectiveness, we understand the importance of healthy consumer spending levels in the overall state of the economy. Because we cannot look to history for a fitting and accurate example, it is difficult to say what Operation Twist will do for the economy; we can only be optimistic about some growth as a result.

Good Investors Ride Out the Storm

In terms of positive numbers, US corporate earnings continue to be impressive. And after second quarter US GDP growth was revised higher, analysts are saying third quarter GDP growth also reached higher than expected levels, somewhere around 2.5%, although numbers are not yet official. Still fighting, the US economy is continuing to push through a year of tough circumstances. Given this environment, and as dreary as things have become throughout the past few months, stocks are selling quite cheaply based on earnings and cash flow. This is a great environment in which to stick with a carefully defined investment program that includes stocks. When we emerge from this soft patch, and the already experienced sell off, we believe those who stayed in will be greatly rewarded.

If our outlook changes, we will be in close communication.

Bond Market Overview *continued from page 1*

The European Problem

We continue to put emphasis on Europe's sovereign debt problem because it is yet to be resolved. We've been writing about the topic for over a year and no permanent solution has been adopted. While some of the debt and refunding issues surrounding the smaller economies in Europe (Ireland and Portugal) have been more easily "absorbed" by the European Union, the European Central Bank, and the International Monetary Fund, the issues surrounding Greece have yet to be resolved.

At the heart of the most recent problems facing Greece's fiscal imbalances and debt burden is the reluctance of other more fiscally responsible nations in the European Union to pay for Greece's inability to show the same fiscal responsibility.

Once again, the problem of having a monetary union of 17 sovereign countries, each with its own governmental bodies and fiscal budgets, becomes a political issue on which not all members can easily reach consensus. It would appear that an expansion of a current mechanism and funding facility (European Financial Stability Mechanism and European Financial Stability Facility) put in place in 2010 is being considered. The facility would require all EU members (including those that need help) to contribute to a fund whose purpose would be to support and guarantee the obligations of all member states. However, as of this writing, the details of how the mechanism would work and how much would be needed have yet to be determined.

While the governments of the member nations work hard at getting the necessary legal authority within their own countries to participate in this accord, the capital markets become more restless and worried about the outcome for Greece, Italy, and Spain. The outcome has the global markets worried about the health of the entire European banking system. It is well known that Germany and France, the two economically strongest nations in the union, have publicly stated that any further financial assistance from them is conditioned upon the private sector (meaning the banking system) absorbing some losses in the event Greece's debt obligations are restructured. The question which has yet to be answered is: "How much?"That, too, becomes a political issue which could have systemic implications. Does a restructuring of Greece's debt impact the European banking system in such a way that it could create another shock similar to 2008? Does anyone want to find out? As a result, we do not believe any outcome would impose such a heavy burden on the banking system that it would risk sending the global economy into another crisis. However, the markets continue to weigh the prospects of a catalyst similar to the Lehman Brothers default, which could trigger another shock and financial crisis.

The Debt Ceiling/S&P Downgrade

The events surrounding the debt ceiling debate that captivated our country's attention for the better part of the summer culminated with a vote on August 1 to increase the US Treasury's legal borrowing authority limit by $2.1 trillion. Increasing the limit in the past had never been met with such resistance as we experienced this time around. The primary reason for the resistance was that increasing the borrowing authority had never been previously conditioned upon reducing the projected budget deficits facing the country. While the majority in Congress and the President acknowledged that real efforts were needed to address our country's deficit spending, reaching consensus was difficult and almost seemed to threaten economic stability. Resistance to increasing the limit that has taken our government debt from $9.6 trillion on August 31, 2008, (before financial crisis) to $14.3 trillion on July 31, 2011, (before the newly enacted limit) was not without merit. Increasing debt by $4.7 trillion in three short years (a 49% increase) is certainly cause for concern.

However, the markets have reacted more to the political uncertainties that surrounded the deficit and debt limit negotiations than to the actual increase. The talk of technical defaults and the possibility of missing interest payments on Treasury bonds did not necessarily exude a great deal of confidence in our ability to keep the economy on the right track. While the talk of default was never a real threat, but more a political talking point, the lack of clear commitment on the part of our government representatives to do what is in the best interest of the economy has put into question the market's future expectations for a sustainable economic recovery.

The "gamesmanship" exhibited by both political parties in Congress and the President was so disconcerting that it also led to Standard & Poor's downgrade of the US government obligations on August 5. There is no question that the catalyst for the downgrade from AAA to AA+ was influenced by the politics of addressing our continued deficit spending without a realistic consensual plan to moderate its projected path for the future. In S&P's own words: *"The downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenge."* It is hard to refute S&P's point of view. However, a rating downgrade is usually the result of increased financial weakness and a greater probability of default. While both of those conditions may be marginally true for the US government at the moment, the reality in the capital markets does not reflect this point of view. So long as the US dollar continues to be the primary reserve currency for global trade, US Treasury securities will be in high demand and a safe haven. US Treasury bonds did not depreciate in value as a result of the rating downgrade.

The Twist or the Pancake?

This past quarter the Federal Open Market Committee (policy setting arm of the Federal Reserve Board) adopted two monetary policy changes that have reduced interest rates.

The first change came at the August 9 meeting which explicitly established a time frame for keeping the short-term Federal Funds rate at 0-0.25% "at least through mid 2013."[1] This policy statement language change was a departure from past statements and the usual accommodative policy of keeping rates low "for an extended period of time." This action has had the effect of putting a ceiling on the 2-year Treasury Note of 0.25%. For much of the summer the 2-year Note yields were in a range of 0.35% to 0.45%. Immediately following the policy language change, the yield on the 2-year was approximately 0.195%, and it currently stands at 0.24%.

The other policy change was announced on September 21, and had a more dramatic immediate effect on the capital markets — positive for long-term bonds and negative for equities. What has been widely publicized as Operation Twist is a monetary policy tool first implemented in 1961 and its intended purpose was to reduce long-term interest rates and decrease the spread differential between short-term rates and long-term rates, or "flatten" the yield curve. That is why I humorously refer to it as the "pancake," because of its flat characteristics. The mechanism used to drive down long-term rates is for the Federal Reserve Bank to simply sell shorter-term Treasury securities (less than 5 years) and reinvest the proceeds in longer-term Treasury securities (6-30 years). Since it was announced, it has reduced interest rates on the 10-year Treasury note marginally from about 1.95% to 1.85%. However, it has had a much greater impact on the very long end of the yield curve by reducing the rate on 30-year Treasury Notes from 3.20% to 2.83%.

These monetary policy changes have not been adopted without creating some doubt as to their efficacy in stimulating the economy. There are also questions regarding the effect a flatter yield curve will have on the risk management decisions of the banking sector, as well as other investors. The announced changes have not enjoyed the unanimous support of all voting members of the FOMC. It is too early to say whether or not these changes alone will have positive effects on stimulating our economy's growth potential and increasing the demand for labor. However, the majority of those on the Open Market Committee do believe that it is a part of their mandate to do whatever possible to maximize employment while keeping prices stable. What may have been an unintended consequence is that the "signal" being sent by the Federal Reserve Board is not so positive and has given market participants cause to doubt the longer-term prospects for our country's economic health.

We believe that our economy still has great potential, but that potential is not being unleashed because of all the uncertainties. In the meantime, we remain vigilant and prudent in our approach to risk management.

[1] Federal Reserve Board of Governors press release dated August 9, 2011