

Fixed Income Investment Outlook

January 2012

A curious incongruity developed in the markets during the second half of 2011. As Treasuries continued their rally that began after the Standard & Poor's downgrade five months ago, U.S. equity markets also rose smartly from their August lows. Normally, a rally in Treasuries implies that investors are in a "risk off" mode, meaning that the fear of economic weakness causes investors to seek safe havens, like U.S. Treasuries. Conversely, a rally in equities is perceived as a "risk on" mode, meaning that the sky is clearing and it is safe to invest again. With the fourth quarter rally in both the "risk on" and the "risk off" markets, the question arises: What is causing this anomaly?

Following the U.S. debt ceiling crisis in July, and the subsequent downgrade of U.S. Treasuries by Standard & Poor's, Treasuries rallied dramatically into year end, sending their yields down by about 1% on both 10-year and 30-year notes. This rally makes sense from a "risk off" perspective. Before the debt ceiling showdown in Washington this past summer, economists' median estimate for 4th quarter real gross domestic product (GDP) growth was 3.4%, meaning that growth was expected to be healthy going into year end. Shortly after the downgrade, which coincided with sharply escalating troubles in the euro zone, economists began a series of downgrades to their growth forecasts, fearing a spill-over effect to U.S. growth. By October, the median growth estimate had dropped to 2.0%. In times of expected economic weakness, Treasuries typically perform better than more economically-sensitive areas of the market, such as stocks. This time was no exception. Another factor that we believe contributed to the rally in Treasuries was the Federal Reserve's (Fed) "operation twist," a program to swap out of shorter-maturity Treasuries into longer-dated bonds, with the stated goal of lowering longer-term rates. This artificial demand for longer-dated bonds definitely produced the desired effect. In fact, given the latest year-over-year change in the Consumer Price Index (CPI) of 3.4%, real interest rates are now negative across the entire yield curve. Finally, we think the mass exodus of deposits from troubled euro zone countries' banks also contributed to the rally in Treasuries. As investors began questioning the safety of Greek, Italian and Spanish sovereign debt, their role as local safe havens was compromised. Some of these deposits have undoubtedly sought shelter in the U.S. market.

While the rally in Treasuries seems logical from a "risk off" perspective, the rally in the U.S. stock market is somewhat puzzling. If, in fact, there is increased worry about Europe and fear of cross-ocean contagion, then why have U.S. stock markets shown such resilience in the past three months? Better-than-expected economic activity is likely the answer. When most economists began lowering their growth forecasts, actual economic releases did not

generally follow suit. In fact, some recent data show that our economy, at a minimum, has stabilized and may even be showing signs of growth. While not widespread, there has been a positive bias to some of the closely watched indicators. Those that have beaten both the consensus estimate and shown improvement over the prior reading include durable goods orders, homes sales (pending, existing, starts and permits), jobless claims (initial and continuing), the unemployment rate, the ADP employment report, the ISM Manufacturing Index, the Chicago Purchasing Managers Index, the Philadelphia Fed Survey, the Conference Board Consumer Confidence Index and auto sales. Additionally, the Conference Board Leading Economic Index also beat the consensus estimate. Consequently, economists have since backtracked and are now increasing their median fourth quarter GDP forecast, which currently stands at about 2.8%.

Despite the upward revisions to growth estimates and a slew of better-than-expected economic indicators, we believe the “risk on” mode may be too optimistic as both restricted private credit and excessive fiscal debt may create structural impediments to accelerating growth. For the past 60 years, every economic recovery has been accompanied by an increase in overall credit. Today the picture is quite different. This is the first recovery in post-war history with little or no growth in overall credit. Private credit since 2008 has contracted by about \$3 trillion. Only government (Treasury, agency and municipal) debt has risen, with the total of private and government debt remaining stagnant at about \$52 trillion since 2008. This may explain why this has been one of the slowest post-war recoveries on record.

In Europe, leaders are also struggling with high levels of government debt and low levels of private credit growth. While the European Central Bank’s (ECB) latest Long Term Refinancing Operation (LTRO) appears successful by some measures, it has not stimulated bank lending. Through this LTRO, the ECB offered three-year swaps to European banks at a 1% financing rate. 523 banks took about €490 billion (\$637 billion) of this three-year facility. The headline number is large, but according to Klaus Baader at Société Générale, banks swapped out of approximately €123 billion of the Main Refinancing Operation facility as well as €111 billion of 3-month LTROs. Additionally, about €46 billion switched from the latest 12-month LTRO allotted in October to this new, longer three-year LTRO. This reduces the net increase in bank liquidity to €210 billion (\$273 billion), which is still a healthy 40% increase over the outstanding balances a week prior. The hope was that this new liquidity would find its way into increased lending, or at a minimum, into the purchases of sovereign debt (a carry trade) but history suggests it will play out otherwise. In 2009, the ECB first offered a one-year LTRO, with 1,121 banks taking €442 billion. What did the banks do with the money? It seems that a good part of it was used to bolster liquidity at the banks and was not lent out. As evidence, we saw a spike in deposits at the ECB of approximately €300 billion. Though Greek debt was then trading at approximately only a 5% yield and the system appeared to be much less stressed than it does today, banks still elected to increase the spread on their existing book instead of extending additional credit, and are largely expected to do the same today. On December 27th, only a few days after the recent LTRO was announced, banks placed about €452 billion (\$591 billion) on deposit with the ECB, which is where they usually park their excess cash. Once again, it does not appear that the banks will be lending that money out productively any time soon.

“Risk on” investments may falter if the economy fails to grow robustly. Economic growth may be hindered until banks globally begin lending and governments make measured improvements in their fiscal balances. It seems authorities in the U.S. and in Europe have largely failed to resolve these issues. There seems to be precious little credit creation and simply too much government debt, which continues to get shuffled around, moving from one pocket to another, creating an illusion that authorities are doing something about the problem. Compounding the problem, as both local and federal governments struggle with increasing debt loads and budget shortfalls, we should expect attempts to raise revenues (read: higher taxes), adding yet another impediment to economic growth and “risk on” investments.

In addition, further gains in “risk off” investments may be labored since real yields on Treasuries are already negative. We believe a continued rally in Treasuries would likely need to be fueled by sustained artificial demand from Washington. Therefore, we continue to favor higher yielding corporate debt. We are particularly focused on shorter-term bonds, as sustained economic growth is not yet a given. While U.S. markets have been relatively healthy during the past quarter, we are not convinced that corrections are a thing of the past and are keeping some cash on hand, which should allow us to buy attractively-priced bonds in any future periods of market weakness. We hope that 2012 will be a better year for investors than 2011.

As always, we thank you for your continued support and welcome any questions and comments you may have.

Sincerely,



Carl Kaufman



Simon Lee

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