Economic & Market Commentary

The second quarter of 2012 was a two pronged affair, with April and May being down months for equities, where high quality stocks outperformed, while June was an up month led by low quality. This was essentially a repeat of the "risk-off/risk-on" pattern that has been a constant companion over the past few years. It resulted in a negative quarter for stocks, and a positive one for bonds, eroding some of the equity strength of the first quarter. Larger stocks did better than small, growth did better than value and high quality did about the same as low, for the quarter as a whole. This reversed the "risk-on" character of the first period, but still left U.S. equities with close to a double digit return for the first half, a result that was better than most other world equity markets.

As in the first quarter, stock market performance was narrow. Only 4 of the 10 S&P sectors outperformed for the quarter, and 5 out of the 10 did so for the 6 months. Materials, industrials, financials and tech were disappointing performers for the 3 months, with energy being particularly so for both the 3 and 6 month time frames.

The overriding focus of attention for financial markets during the quarter was the European crisis, culminating in the Madrid Summit meeting the last week of June. The outcome of the latest edition of a European Union Summit exceeded low expectations and spurred a large rally in risk assets on the final trading day of the quarter. The financial markets were not expecting much to materialize from the talks, so there was a low hurdle to trigger a rally. The actions taken by the participants:

- allowing the European Stability Mechanism (ESM) to lend directly to troubled European banks, rather than lending to the Sovereigns which would add to their debt burden,
- not requiring senior status for ESM debt, thereby not subrogating existing debt,
- providing rescue funds for Italy if it meets reform targets,

go a long way toward bailing out stressed European banks and mitigating a bank run crisis (the addition of deposit insurance would be helpful there as well). These actions serve as a long punt down the field, but don't, in themselves, score points. The ESM has yet to be funded, and the creation of a single bank supervisor to be run by the European Central Bank (ECB) won't be established before the end of the year. So we are hardly out of the woods, and still have some distance to go. They do, however, indicate a willingness on the part of European leaders to work together, which is a positive step.

The problem with the European situation is that it is not an economic issue, but at the core, a political one. The rising tide of populism and nationalism sweeping the area can be ascribed to fears of the loss of sovereignty. Stressed states are being required to abide by the new rules of the game, which means giving up control. Banking systems must unify and ideally fiscal systems must as well. A bigger problem than liquidity or solvency is generally considered to be the competitiveness of the peripheral states. It has been said by some that the southern tier must endure a further 25-30% decline in their standard of living before those states become competitive in world markets. The biggest question is - are they willing to trade solvency for austerity imposed by people they did not even elect? Many believe the original concept of the euro has not delivered on its promise, as there has not been the economic convergence that was expected with a common monetary policy. Instability arose from credit overshoots, weak cost controls, and weak regulatory oversight. It is difficult to ensure stable economic performance across countries with major differences in structural reform and cultural attitudes. As a result, the euro saga will not be played out in months, but probably years. So the Madrid Summit produced a long “kicking of the can down the road”, and like prior Summits has succeeded in buying time. The never-ending hope is that some of these longer term issues will be addressed in the interim. Our attitude is – “don’t hold your breath”. Will the euro collapse? The conventional betting is it will not. That result would be bad for Germany and others in the northern tier. They benefit from a weaker currency than the alternative, which supports their exports and growth. If there were a collapse, growth would stagnate and inflation rise, an outcome that is anathema to Germany. So the current consensus feeling is that Germany will reluctantly do whatever needs to be done to keep the Union intact; however, the Germans’ resolve is waning.

In the meantime, Europe is in what may be a deep recession, which could spill over to the U.S. The Madrid initiatives should mitigate a run on the European banks, which hopefully will prevent the chaos of another Lehman moment. However the odds of a spill over are higher than they were 3 months ago.

In addition to Europe, we are faced with a troublesome U.S. economy. Three months ago, we wrote that the U.S. economy was closer to escape velocity than stall speed. In this short period the situation has reversed, and “double dip” is back in the headlines. It is not new news that this recovery has been the weakest in the post war period. Edward Lazear (former Chairman of the President’s Council of Economic Advisors from 2006-2009) wrote in a Wall Street Journal op-ed that “at this point, the economy is 12% smaller than it would have been had we stayed on trend growth since 2007.” The huge amount of liquidity that has been injected into the economy (QE1, QE2, Operation Twist, etc.) has obviously not done the trick. Investors have become addicted to these injections, reacting to them with jolts to risky asset performance. However, like many addictions, these injections have produced diminishing returns in economic stimulus. The extension of Operation Twist and the possibility of QE3 will have a muted impact on economic activity. The fact is that at this level of interest rates monetary policy has a limited impact on the real economy. Other than bolstering balance sheets and providing liquidity the effect is minimal. The solution for the real economy lies in the realm of fiscal policy: ensuring clarity and establishing a growth agenda. Neither of these are currently present and, unfortunately, we will probably have to wait until after the election to see if we get these policies.

In the meantime, we are faced with a weakening domestic and worldwide economic outlook:

- weak domestic GDP and an employment picture that has softened
- US elections and fiscal paralysis
- the well-known fiscal cliff – the expiration of earlier tax cuts, and possible sequestration with the attendant fiscal drag
- the Euro zone financial crisis and recession which will impact the U.S.
- a Chinese economy that shows signs of softening
- the continuing worldwide deleveraging that will take years to unwind

All these factors increase the odds of a domestic double dip. When we wrote last we would have put the odds of this well below 50%. Given today’s circumstances we would have to say the odds have moved closer to 50% that we are in a coordinated worldwide slowdown. In spite of all these negatives we are not ready to throw in the towel on the U.S. economy. For the past several quarters we have said that we believed we were in a protracted period of subpar, below trend, growth. We still believe that, and still believe we can show positive growth. We are inclined, though, to temper our expectation of +2-2.5% real

GDP growth to perhaps +2% minus, going forward. Granted some of the elements of the economy – business spending, exports, and government – currently look softer. Yet energy price declines, and expanded consumer balance sheets are helpful, and housing appears to be bottoming. So with fingers crossed, and keeping a close eye on all the above, we think we can muddle through this rough period.

It is well accepted that earnings growth has been the prime mover of stock prices since the market bottomed in March 2009. Given the many risks in the economic outlook and volatility of the markets, the equity risk premium (ERP) increased and P/E multiples declined, while reported earnings grew substantially. As is usual, we are entering another earnings reporting cycle, and the second quarter reports should be very interesting. The rate of change in quarterly earnings has been declining for the past couple of years, with the last quarter being barely positive. The awaited reports and accompanying guidance given by managements will clearly set the tone for equity performance for the coming months. Analysts have been slow to temper their expectations (this is not unusual at inflection points), so the markets could be in for a rough patch. We have felt that some growth was warranted in 2012 S&P 500 earnings, and had centered on a $100 per share figure. This had been below the consensus figure from most analysts. They are now moving down the scale toward that figure, so the upcoming reports will be telling. We have also tried to incorporate the deteriorating European economic situation into the earnings estimates we use to value individual companies we follow.

At today's level, the U.S. equity market is neither cheap nor dear. But with negative real returns from high quality bonds and the U.S. economy more vibrant than most, domestic stocks are probably the best property in a tough neighborhood. With modest nominal GDP growth, margins that come down over time, an ERP that remains elevated and a dividend yield of about 2.5%, U.S. stocks could produce an average annual total return in the 6% area over a few years period in our opinion.

These paragraphs describe the situation as we see it today and present the environment that we must navigate in managing client assets. To us it speaks loudly to staying balanced, not making any outsized bets on outcomes we have little ability to accurately predict, and remaining vigilant for signs that economic, financial and political conditions are changing for the better or worse. We will continue to search for individual businesses that have the prospect of earnings gains, whose stocks are priced below what we think is fair value, and invest in them at a time when we think we can realize that value.

Fixed Income Review and Outlook

Unlike stocks, fixed income returns were positive for the major sectors in the second quarter, ranging from a little over 1% to a little less than 3%. Overall, the Barclays Aggregate Bond Index generated a 2.06% return, bringing the year-to-date (YTD) total to 2.37%. A breakdown of the sector returns follows. Treasuries were the best performer during the quarter with a 2.83% return. Through June 30, Treasuries have provided 1.51% to investors.

Heightened concerns about the status of European banks, trading losses at major U.S. banks and a weakening labor situation in the United States encouraged a flight to quality trade around the world. On May 6, Greece held a national election to determine the new Prime Minister. When no clear winner emerged, attempts were made to form a coalition government. These attempts failed, in part because of the strong showing of a left-leaning party that favored reneging on the agreements to the latest bailout from the European Central Bank. This action would have brought the soundness of the current Greek bonds into question. At the same time, slow growth in Spain and Italy put downward pressure on those countries' bond prices, pushing yields towards the 7% level that is viewed as the point where countries have to look for a bailout. The exposure by the European banks to the sovereign debt of those countries called into the question the strength of the banks.

Headline risk for the banks resurfaced in mid-May, when JP Morgan reported a large and unexpected loss from credit derivative trades. To be clear, JP Morgan was never in any real financial danger. The high end of the loss estimates, $9 billion, represents a small part of the company's balance sheet. But it served to focus attention again on banks and the need for adequate capital and risk controls. The Dodd-Frank legislation is designed to address these concerns. Part of the problem is the confusion produced by Dodd-Frank, as many of the rules governing the banks and their operations have yet to be written. The banks are uncertain as to how much capital they will be required to hold. In times of uncertainty, investors prefer Treasuries. Dealer holdings of Treasuries hit an all-time high in June.

Closer to home, weaker economic data helped drive Treasury yields lower. Job growth in the US slowed in the second quarter. In all, 225,000 non-farm payroll jobs were added in Q2. This follows the 677,000 non-farm payroll additions in Q1 (which may have been helped by the milder winter and difficult seasonal adjustments) and was the smallest quarterly increase since 2010. Following the release of jobs figure on June 1, ten-year yields fell to a post-war low of 1.45%. Real yields, stated yields less the rate of inflation, remain negative and make for an unattractive long term investment.

The Federal Reserve continues its efforts to provide fuel for the economy. Monetary policy remains accommodative as the Fed holds its overnight borrowing rate near zero. In June, Fed Governors extended Operation Twist from June 30 to December 31, 2012 and added an additional $267 billion to the program. The intent of "Op Twist", where the Fed sells its shorter maturity Treasury holdings and purchases longer maturity Treasuries, is to lower long term interest rates and encourage bank lending. They have met with some success as rates are certainly lower and bank lending standards have relaxed a little in the last year.

We continue to expect that Treasury rates will rise modestly. However, the timing of the increase is hard to predict. Political uncertainty in Europe and weaker economic fundamentals worldwide could prevent a strong move upwards in yield. Headline inflation will decline with falling energy prices. But with the ten year note yielding 1.65%, investors are barely being compensated for year over year CPI growth. It is for this reason that we expect to maintain an underweight position in Treasuries and have modest interest rate sensitivity.

Agencies returned 1.42% for the quarter bringing the year-to-date figure to 1.66%. Demand should remain strong for agencies as investors who require highly rated securities will continue to provide a market for this asset class. Agencies also benefit from low levels of net issuance- that positive technical aspect helps drive spreads tighter compared to Treasuries. While we expect that bulleted agencies will continue to benefit from scarcity value, we believe that spreads are too tight and prefer to use callable agencies with final maturities of 2016 and earlier as a yield enhancing strategy.

Corporate bonds offered investors 2.52% for the quarter and have contributed 4.65% year-to-date. Corporates remain the investment vehicle of choice for many investors in this low-yield, slow growth environment. Despite record earnings and high cash balances, corporate spreads over Treasuries remain wide to historical values. In addition, the yield pick-up of corporates over both Treasuries and Agencies is almost 2%. The combination of wide spreads and the low all-in yields available in Treasuries and agencies have encouraged additional allocations to investment grade and high yield corporates. While dealer inventories of Treasuries are at all-time highs, inventories of corporate bonds are at close to all-time lows. The uncertainty created by the Volcker Rule, a provision in Dodd-Frank named for former Federal Reserve Chairman Paul Volcker that forbids proprietary trading by banks, plays a role here. There is some debate as to exactly what constitutes proprietary trading and many dealers chose to adopt the conservative policy of less "positioning" or buying bonds into inventory until greater clarity is achieved.