Economic & Market Commentary

Investors got a large liquidity fix in the third quarter. European and U.S. monetary authorities indicated they would do "whatever it takes" and for however long it takes to protect and right their respective economies. In addition, the central banks of Japan and China have committed themselves to aggressive policies of monetary easing. In all, more then 250 stimulative policy initiatives have been announced worldwide, over the past 12 months. Equity investors reacted to these moves in Pavlovian fashion, and the S&P 500 was up 6.4% for the quarter and 16.4% for the year to date. Since bottoming in mid-June, that index is up 12%-13%, a surprisingly powerful performance.

Stocks did better then bonds for both the quarter and the year to date, and the U.S. was a better place to be invested than most other world equity markets. As has been the case for most of the year, large capitalization stocks have done better then small, and growth better then value. Risk and lower quality continued to dominate equity performance during the period, as the monetary actions taken are assumed to reduce economic risks. The narrowness of the market's performance continued as only 5 of the 10 S&P 500 sectors outpaced the index for both the quarter and year to date. Consumer discretionary, financial and technology companies were notable outperformers for the three and nine months, while the more defensive issues lagged for both periods. The Energy sector turned in a good quarter, although this sector lagged for 9 months.

Liquidity injection and aggressive actions by the world's central bankers were the overriding focus of the third quarter. This began with Mario Draghi's commitment to purchase the peripheral European countries' bonds (if they come hat in hand and accept the ECB's austerity demands), and the German Constitutional Court's vote to back the European Stability Mechanism (ESM). It was followed shortly by the U.S. Federal Reserve's announcement that it would do whatever it takes for however long it takes, to support the U.S. economy and bring unemployment down. The logical question to ask after these measures is what impact has the past 3 or so years of extraordinary monetary stimulus had on the U.S. economic situation. We know it initially served to stabilize a very fragile economy and banking system, which in turn took pressure off the risk premium accorded financial assets, allowing prices to rise. Inflated asset prices have an obvious effect on the owner's balance sheet, and promote a feeling of well being and a willingness to spend. It is clear that the monetary authorities view asset price inflation as an important transmission mechanism for monetary policy. The stimulus importantly served to lower interest rates – short rates significantly and long rates less so. These actions were aimed at encouraging borrowing, and consumption (particularly mortgage borrowing which would aid a housing recovery). Lower rates also reduce the discount factor for stocks, a positive for stock valuations. Reduced interest rates mean lower borrowing costs for corporations as well, which boosts earnings. The Bank Credit Analyst calculates that this fact was a major contributor to corporate profit growth over the past few years. Finally these stimulus programs could impact a country's foreign exchange rates (lower them- all things being equal) which could aid exports. In theory, these are results that might be expected from such a program. However, except for asset inflation, and to some degree housing, they have been of little help to the real economy.

The U.S. economy is bumping along, with the last quarter reported at a revised +1.3% real GDP growth rate, with expectations going forward about the same. As we have written in the past, "At this level of interest rates, monetary policy has little impact on the real economy. The solution for the real economy lies in the realm of fiscal policy; ensuring clarity and establishing a growth agenda." Our monetary authorities recognize this, and realize that none of the fiscal issues will be addressed before the election, so in effect their actions are an attempt to buy time. Europe is in the same boat, and the ECB's actions are also "time buyers". We have said before that the resolution of the Euro problems will probably take years not months. These latest actions do allow time for the peripheral countries to increase their competiveness and move more clearly toward a banking and fiscal union. Whether that can be done remains to be seen.

The massive amount of liquidity that has been provided to the U.S. economy has not yet created the problem of escalating inflation. The primary reason is that the liquidity has not yet found its way into the real economy. In economist speak, monetary velocity has declined -money has increased faster than economic growth. The liquidity sits on the balance sheet of the Federal Reserve in the form of excess bank reserves. The Fed's balance sheet is now about $3 trillion, with slightly more than half in these reserves, on which the Fed pays interest of 25 basis points. Obviously, were these reserves to find their way into the real economy via bank lending, and real economic growth to accelerate; rising inflation could become a major issue – one which could be painful for the economy and especially investors. This then begs the question of how does the Fed unwind this bloating balance sheet.

It is widely recognized that the U.S. economy is operating well below its potential. This output gap has failed to close as private sector deleveraging has prevented the normal post-recession strong cyclical recovery. The deleveraging process that most thought had started in late 2008 has been focused only in the private sector as government debt has skyrocketed and offset most of the private sector deleveraging. However once this output gap eventually closes, the Fed will be faced with the prospect of potentially much higher rates of inflation. So unwinding the balance sheet becomes an important topic. The Fed says "we have a plan and the means." That may be true, but it begs repeating the question- how? The average maturity of the Fed's holdings has increased to about 10 years. Four years hence, that maturity will be 6 years, so a run off of bond maturities does not do the trick. If the Fed were to stop paying interest on reserves, and gently encourage banks to lend or reinvest in higher yielding securities, they could begin a program of selling their holdings to these banks. This could go a long way toward reducing the bloat. Of course, the current snapshot of the balance sheet is just that, and does not take account of additions due to the most recent iteration of Quantitative Easing (QE). However, it might provide the beginnings of a solution for what could be a major problem.

The "whatever it takes" world we are in would normally justify higher asset prices. However we are hardly in a "normal" environment. There are many other variables that affect the equation, which are immune to monetary policy.

- The U.S economy is stumbling along at a declining rate of growth. Last quarter's real GDP growth was revised from +1.7% to +1.3%, and the outlook continues to be in that range. Job growth remains sluggish. We expect these circumstances to persist for some time.
- The fiscal cliff of expiring legislation can have a negative impact estimated to range between 1½% and 4% of real GDP. Even at the low end of estimates, the impact could eliminate a year's growth.
- Europe continues to be mired in a recession that shows little sign of ending.
- China's economy continues to slow, at a time when there will be a once in a decade handover of political power next month.
- The geopolitics of the Middle East are roiled and could blow up at anytime, causing immediate issues on the energy front, and lasting issues on the political front.
- Finally, and perhaps most importantly, the U.S. elections will set the stage for our future path for many years.

So it seems that liquidity injections have trumped economic fundamentals, at least for the time being. However, at some point, focus must return to economic fundamentals and the uncertainties of 2013. After all, it is economic growth and earnings that drive stock prices. Yet for the past few months it has been a declining equity risk premium (rising price/earnings ratios) caused by increased liquidity that has carried the day. Once again, we are in another earnings reporting period. We expect the aggregate year over year reports to be negative for the first time in 3 years. (Last quarter the aggregate excluding financials was negative.) This should leave 2012 earnings per share for the S&P 500 at about $100, about the figure we expected at the beginning of the year. Next year is anybody's guess, given the imponderables mentioned earlier. The one thing we do feel confident of is that the consensus expectations of $110-$112 for S&P 500 earnings are too high. Revenue growth will be subdued and profit margins are close to all time highs. Even those most optimistic realize that the margin level will come down.

At the end of the last year, we also thought that earnings expectations were generally too high, and would have to come down during the ensuing 12 months. Europe was a mess, and the U.S. economy was struggling with a dysfunctional body politic. We saw many things that could go wrong, and a few things that we could get excited about. The S&P began the year at about 1250. Valuations were not stretched, and multiples, in general, were compressed. So we viewed the market of stocks as fairly valued, given the circumstances. Our expectation was that stocks could produce a total return of 6-7%, assuming economic fundamentals held together. As we look back at the past 3 quarters, we find we have been correct in most of our fundamental assumptions about how the year would unfold. We did not, however, anticipate the massive liquidity response here and across the globe, which has trumped weak fundamentals, and driven multiples higher. Looking forward, we find many similarities to our position 9 months ago. We again think earnings expectations are too optimistic, and the head winds described earlier are many. The main difference is that the level of stock prices is up close to 14%. Multiples have increased and valuations are no longer highly compressed. Our conclusion is that the market, as a whole, is at best, fairly, to modestly overvalued. This makes finding situations that represent value more difficult. We continue to look for businesses that have sound and growing economics that are undervalued. The current environment puts a premium in the short-term on trying to be right on earnings surprises and avoiding the potholes that lurk in the path. It also persuades us to remaining balanced in portfolio structuring, a posture we have advocated for the past few quarters.

Fixed Income Review and Outlook

Fixed income returns were positive for the major sectors in the third quarter, ranging from a little more than ½ of 1% to almost 4%. Overall, the Barclays Aggregate Bond Index generated a 1.58% return, bringing the year-to-date (YTD) total to 3.99%.

Treasuries lagged the market with a 0.57% return for the quarter. Year to date through the end of September, Treasuries have provided 2.08% to investors. Looking at Treasury yields at the end of June versus those at the end of September, an investor might reasonably assume that the market was dull. After all, two year yields started the quarter at 0.30% and ended it at 0.23%. Ten year yields fell just 2 basis points to 1.63% while thirty year yields rose from 2.75% to 2.82%. However, during the quarter, ten year yields traded in an almost 50 basis point range, touching a post-war low of 1.38% in late July. The thirty year or long bond yields touched a low of 2.45% in July and a high of 3.09% in September. In a two month period, the thirty year traded in a 64 basis point range. To put that in context, the long bond lost over 10% of its value from the July low yield to the September high.

International concerns continue to weigh on US Treasury yields. While Greek financial difficulties have been in the headlines since 2009, it was Spain that helped drive the market in the third quarter. Spain, the fourth largest economy in the Eurozone, looks likely to need aid in the near future. Spanish banks are saddled with bad debt left over from the collapse of the Spanish housing market; unemployment stands at 24% (52% for those under the age of 25); and several regions, including its most populous, Catalonia , are talking about secession. On July 24, following evidence of a deepening recession, Spain's 10 year bond yield reached 7.50%. At that level Spain would not be able to service its debt. It was on July 24 that the US 10 year yield hit the 1.38% level. The low yield on the long bond followed the next day. However on July 26, Mario Draghi, the European Central Bank (ECB) President, gave a boost to the market when he stated that "the euro is irreversible" and that the ECB stood ready to do whatever it took to preserve the euro. A "risk-on" period ensued with 10 year Spanish yields falling about 40 basis points and 2 year yields falling more than 75 basis points. Here in the US, 10 year yields rose about 15 basis points on the news.

Draghi's plan is to buy the debt of the sovereign countries via Outright Monetary Transactions (OMT), with the caveat that a country must first ask for a bailout and agree to the conditions set by the ECB. A stressed Spain has yet to do so. Spanish yields fell following Draghi's statement. Spain, in turn, is pointing to the lower yields resulting from the announcement as evidence that they don't need a bailout. However, Spain has more than 45 billion euros in debt to refinance between now and year end. If they choose not to seek a bailout, the interest levels at which they would be forced to roll the debt could approach 7% again. The Spaniards know that is not in their best interest. We see this delay as a tactic to negotiate the best terms possible for a bailout prior to the formal request.

Closer to home, fluctuating economic data provided little direction for yields. Job growth in the US picked up in the third quarter. 323,000 Non-Farm Payroll jobs were added in Q3. This follows the 225,000 Non-Farm Payroll additions in Q2. While encouraging, these figures continue to fall short of the 150,000 per month needed to keep up with population growth or the sustained addition of 250,000 monthly to shrink the unemployment rate by 1%. Also, the ISM Manufacturing Purchasing Managers Index came in below 50 three consecutive times in the June – August time period. That hadn't happened since 2009. The PMI is a closely followed indicator of the health of the manufacturing sector. Numbers above 50 indicate growth while those below 50 indicate a slowdown. On the bright side, housing continues to show signs of strength. The National Association of Home Builders Survey rose to its highest level since June 2006 and sales of new and existing homes continue to trend up. Historically housing has contributed about 5% to GDP, while now, it stands closer to 2.7%. A return to "normal" levels would be a big boost for the real economy.

The Federal Reserve continues its' efforts to stimulate the economy. At the end of the meeting on September 13, the Fed announced its intention to buy $40 billion of mortgages per month with no end date cited, continue the Maturity Extension Program or Operation Twist through December of this year and hold borrowing rates low until 2015.

These moves were extraordinary for a number of reasons. Never before had the Fed committed to an open-ended program like this. Prior bond purchase programs had set termination dates. This new one, commonly known as QE3, does not. The Fed by targeting the first of its mandates, full employment, as a goal of the program is putting less emphasis on the second, stable prices. The reasoning is that by purchasing mortgages the Fed will be able to encourage lower mortgage rates which will in turn provide more stimulus to housing and add to growth. Mortgages rates did fall in the weeks following the announcement. Whether lower mortgage rates lead to higher growth remains to be seen. In addition, the Fed did not rule out further Treasury purchases. This leaves the door open for more purchases later if buying $480 billion of mortgages annually fails to have the desired effect on the real economy.

The Fed's actions have direct implications on the positioning of bond portfolios during the next quarter. We continue to expect Treasury rates to rise modestly. Real rates (nominal yields less the inflation rate) continue to be negative out to the ten year part of the Treasury curve. With expected GDP growth of 1.5% and an expected inflation rate of 2%, one could argue that the 10 yr yield should be closer to 3.5%, more than double the current level. We think the Fed's actions have postponed a move toward higher rates further into the future than previously anticipated. The front end of the curve should stay stable as the pledge to keep rates low into 2015 will anchor it for the next few years. Potential Fed involvement further out the curve and slow growth will serve to suppress longer rates below their normal level. Our plan is to maintain an underweight position in Treasuries and have modest interest rate sensitivity.

Agencies returned 1.11% for the quarter bringing the year-to-date figure to 2.79%. Demand should remain strong for agencies as investors who require highly rated securities will continue to provide a market for this asset class. Callable agencies, which provide greater yield but also have greater interest rate risk, can be used as a short duration corporate or mortgage substitute. Given our expectation of low interest rate volatility in the front end, a lack of available high quality corporate bonds and a Federal Reserve buying $40 billion mortgages a month, callables are a good option for adding income and yield to a portfolio.

Investment grade corporate bonds offered investors 3.83% for the quarter and have contributed 8.66% year-to-date. We intend to remain overweight here. Corporate Fundamentals are good. High cash balances and low debt levels should allow companies to weather the low growth environment we are experiencing without adverse effects on credit quality. Given our expectation of lower earnings and slow growth, we've reduced our exposure to economically cyclical credits in favor of higher quality names with less volatility.

As is the case with Treasuries, the Fed's application of QE3 has implications on our positioning of the corporate bonds in our portfolios. We expect the intermediate part of the Treasury curve to remain steep. To take advantage of the steepness of the curve, we are positioning bonds that will benefit from rolling down the curve. For example a bond that matures in 2019 or 2020 and benchmarked to the 10 yr note will soon be benchmarked to the 7 yr which is about 40 basis points lower in yield. The idea is that as the bonds roll down the curve the spreads over Treasuries will compress as the market naturally tries to maintain upward sloping credit curves.

Mortgages trailed the overall index in the third quarter, returning 1.13%; mortgages have returned 2.80% thus far in 2012. The Federal Reserve's decision to buy mortgages in such large size for an open ended period had a direct effect on the market in September. Spreads over Treasuries collapsed, as securities available for purchase became harder to find. Following the initial flurry to buy mortgages ahead of the Fed, some profit taking resulted and spreads widened modestly. We see mortgages as a good alternative to short corporates and agencies and expect to add to them on weakness.

Municipals bested the returns of the Barclays Aggregate in 3Q, returning 2.32% and have outperformed the Aggregate year-to-date with a 6.06% return. There are some signs the rally may be getting long in the tooth.

We enter the fourth quarter cautiously optimistic on the macro environment. The elections on November 6 will remove some uncertainty from the markets. The fiscal cliff will most likely be addressed. In September, Moody's warned of a potential downgrade of the US if any talks fail to produce policies aimed at reducing the debt/GDP ratio. As long as the dollar remains the reserve currency of the world and US Treasuries remain the "flight to quality" alternative, rates should not spike even on a downgrade. But, the US has $4.5 trillion in debt to roll over in 2013 – 2015 and it is critical that our borrowing costs remain contained. If you want to know what happens when they do not, look to Europe.

In the portfolios, we've increased the quality of our holdings and positioned some bonds to take advantage of the steepness of the yield curve. Our mortgage holdings should not be subject to large prepayments and have good credit metrics. We think the strategy of constructing portfolios focused on quality, generating income while taking advantage of yield curve opportunities is the right one for the remainder of the year.