



**QUARTER IN REVIEW**

**Weakening confidence in the global recovery and concerns about the survivability of the euro prompted investors to flee to the safety and liquidity of U.S. Treasury bonds, German bunds, gold, the U.S. dollar and Swiss franc.**

The rally in U.S. stocks that had begun in March 2009 peaked in late April after gaining 72% (annualized) as measured by the S&P 500. Volatility escalated, including an early May “flash crash” that has yet to be fully explained. At this point, the correction in U.S. stocks is about 15%. After the meteoric rise, a correction is normal. Among global markets, only Canadian and the emerging

**ONLY Canadian and emerging markets** | **Avoided double-digit losses**

markets avoided double digit losses. In a departure from typical patterns in a stock market de-

cline, smaller-capitalization stocks declined less than larger-cap stocks. Commodity prices fell as confidence in future global growth waned. The tragic oil spill in the Gulf of Mexico and moratorium on off-shore drilling did not prop up oil prices. Risk premiums on all types of corporate debt expanded; spreads widened on high quality corporate debt from about 1.5 percentage points to over 2%, while below investment grade credit spreads widened from less than 6 percentage points to more than 7%. At quarter-end, the yield on the 2-year Treasury note hit a new all time low, while the 10-year Treasury yield fell below 3%, a level not seen since the height of the financial crisis. This was the worst quarter since the fourth quarter of 2008 for financial markets.

Passage of the 2,319 page Dodd-Frank Wall Street Reform and Consumer Protection Act before July 4<sup>th</sup> appeared assured until late June. Last minute horse-trading continues, but the outcome is noteworthy for what the bill fails to address as much as for what it does. Major financial institutions face more stringent capital requirements and will be required to divest or curtail certain proprietary investing activities, while a new Consumer Financial Protection Bureau will be started. However, the legislation does not confront the future of the government sponsored enterprises (GSEs), such as Fannie Mae, nor does it address the key regulatory issues raised in the Paulson Blueprint released by the Treasury Department in March 2008 that advocated for modernization of the U.S. financial regulatory structure. Only the U.S. still has different regulators for cash securities (SEC) and derivatives (CFTC) and lacks one national insurance regulator. The new legislation does not appear sufficient to avoid a future financial crisis.

**The National Debt**

While business and consumers have reduced their leverage, government borrowing has exploded! Non-financial corporations have the largest cash balances since 1952, estimated at over \$1.87 trillion. Consumers’ financial obligations ratio, which includes monthly mortgage payments, rent, property taxes, credit card and auto payments as a percent of disposable personal income, has declined from a peak of 14% in the winter of 2007-08 to 12.5% at the end of March. In addition, the savings rate is up to about 4% from zero before the recession, but it remains below the mean rate since 1960 of 6.9%. The government needed to step into the breach during the “Great Recession” in order to avoid even more hardship and calamity. This spending should abate. Some programs, for example, TARP, have provided a return on the investment. The long-term budget problems lie in Medicare and Social Security entitlements, which are significantly under-funded. State governments suffer from unfunded federal mandates but cannot run deficits nor have the printing press of the Federal Reserve and, as a result, have made painful cuts to services, entitlements and employment.

**Savings rate remains below mean rate of 6.9 %**

The national debt must be addressed if the U.S. is to avoid the problems other debtor nations face. The federal deficit (amount borrowed in a fiscal year) as a percent of Gross Domestic Product (GDP) is estimated at 9.2% in fiscal 2010 and exceeds 6.5% in fiscal 2011. The Congressional Budget Office estimates that net federal debt (the cumulative amount of debt owned by the public, which includes foreign and domestic institutions and individuals but excludes inter-government debt holdings, such as Treasuries owned in the Social Security Trust Fund) is about 60% of GDP in the current fiscal year, up from 36% in 2007. On June 30, the White House Bipartisan Commission on Fiscal Responsibility issued its report calling for more spending cuts than tax increases as a means of addressing the deficit problem. The suggested cuts are centered on health care and entitlement spending. Tax increases are likely as the Bush tax cuts of 2001 and 2003 expire, although some aspects of these tax cuts for middle and lower income tax payers may be retained, at least for now.

	Percentage of GDP	
	Federal Deficit	Federal Debt (net)
1970	0.3	28.1
1990	3.8	42.3
2007	1.2	36.2
2010E	9.2	60.3
2011E	6.5	65.3

Source: Estimates based upon CBO, Federal Reserve and the White House Budget

To get an appreciation of the current situation, we reviewed the tax and spending histories of the Reagan and Clinton presidencies. Reagan cut the top marginal tax rate on individuals from 70% to 50%, then to 38.5% but closed loopholes, while increasing defense spending. Unemployment was almost as high at the beginning of the Reagan presidency as it is now, but gradually declined. The deficit as a percent of GDP was 5.9% in 1983 and dropped to 2.8% by 1988. Under Clinton, top marginal tax rates were raised from 28% to 39.5%, the cap on Medicare taxes was removed and Social Security taxes increased for top earners. After the 1994 Republican mid-term election victory, Clinton cut spending on entitlements and shifted government spending from defense to technology. During the Clinton presidency, deficits disappeared and there was a surplus. Readers may recall that in the *Perspectives* issue of April 2009, we discussed Robert Hormats' *The Price of Liberty*. With the exception of war and national calamity, the U.S. has had a balanced budget and repaid its debts. Since 2001, we have been engaged in the "War on Terror" and expanded entitlements such as the Medicare Prescription Benefit and the Affordable Care Act, which some view as reminiscent of the 1960's "guns and butter" policies.

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**The challenge we face is how to reduce or eliminate annual deficits in order to stem the ever mounting national debt.**

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There are no easy answers. The likely path includes tax increases and spending cuts, as proposed by the Commission on Fiscal Responsibility. The political challenge, as always, is how. This is now the number one concern of voters.

## The Dollar Conundrum

The national debt is financed by U.S. and foreign investors who buy U.S. Treasury securities. Currently, about half of the privately held U.S. Treasury debt is owned by foreign investors. In addition to our federal deficit, the U.S. also runs a trade deficit and has done so since 1971. In 2009, the trade deficit approximated \$375 billion of which almost \$227 billion was with China. China is a major owner of U.S. Treasury securities, bought with monies accumulated from the sale of goods to U.S. consumers.

Will foreigners continue to invest in U.S. Treasury debt given the budgetary problems we have? The events of the last few months in Europe highlight the fact that this is a problem for all developed economies. Although in Japan, domestic savings are sufficiently high to allow its deficit to be financed internally. Not so for the U.S. where the savings rate is low. An article appearing in the *Financial Times* on June 30 highlights the dollar conundrum. "The dollar's role as the pre-eminent reserve currency is not an issue." "To supply the world's risk-free asset, the country at the heart of the international monetary system has to run a current account deficit. In doing so, it becomes more indebted to foreigners until the risk-free asset ceases to be risk-free."

Japan

Deficit  
financed  
internally

Globalization has changed the dynamics of finance and trade. Moving money is easy; the press of a computer button moves money anywhere in the world. Moving materials, such as food, oil and non-perishable goods, around the world is not too difficult with containerization, tanker ships, trains and cargo planes. While moving production is more challenging, factories can be located globally with modern transportation. Service businesses are easily handled anywhere that offers the internet. However, moving people is problematic. Therefore, people bear the brunt of a country's economic adjustments. But, it can be done.

Ireland

Consider Ireland, its economy grew 2.7% in the first quarter after a

15% contraction over the prior two years. The government addressed competitiveness, public finances and the banking system while cutting public salaries 15% and welfare 10% in order to turn around its financial situation.

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### Currency values are the equalizers.

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If there is too much of a currency floating around the world, the currency declines. A lower dollar makes foreign goods more expensive and adds to inflation. It also raises the cost of borrowing. When will the amount of dollars needed to support our debt dilute foreigners' appetite?

**Capital  
markets  
serve  
as the  
disciplinarian**

The recent decline in the euro has made European goods more affordable and borrowing more expensive for Europeans. This should help European export growth and offset some of the negative effects of the austerity measures, such as welfare reduction and cuts in government workforces and services that are being adopted across Europe.

What is the tipping point for foreign investors in the U.S.? The Chinese have announced that the Yuan will float gradually higher, making their goods more expensive for others and imports to China less so. They may also need to encourage more domestic consumption to reduce their trade surplus. The Chinese have begun to diversify their holdings of sovereign debt investments. U.S. consumers must become better savers. And, the Federal Government must address the yawning deficits.

Reducing debt can occur two ways: repudiate it through restructuring and/or inflation or gradually pay it off, which can be deflationary and result in very slow growth. Which path will have a significant impact on investments? Uncertainty surrounding the future direction of this policy is a significant contributor to today's volatility.

## Strategy Considerations

This is a tough environment for investors. Interest rates on the safest securities, i.e. short-term investments and Treasuries, are at historic lows. An important aspect of investment decision-making is understanding liquidity flows. Monetary policy has provided lots of liquidity to banks that are investing in government bonds instead of making loans. At some point, monetary policy will become less accommodative and banks may begin lending more. Based on Fed pronouncements about short-term interest rates and the continued need for banks to raise capital, this liquidity is likely to be a plus for bond markets. Corporations have enormous cash balances that are being used to raise dividends and may be used to acquire other companies. So far in 2010, dividends were increased by 123 companies in the S&P 500. Money market balances appear high. However, mutual funds' equity reserves are near record lows as investors search for a return on investment, which leaves little buying power.

**Liquidity,  
likely  
a plus for  
bond  
markets**

The low level of interest rates raises concern about investing in longer maturity bonds even though the added yield for extending maturity is very high. Some investors are concerned about the effect of rising short-term interest rates at some time in the future. Rising interest rates erode the price return on bonds; the longer the maturity the greater the price decline. However, as our Director of Fixed Income Strategy, Wendy Stojadinovic, CFA, explains in today's environment, short maturity bonds may not provide a better return than longer bonds even when interest rates rise.

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**The key to determining the effect of maturity on a bond's total return is the steepness of the yield curve and how quickly rates rise.**

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Currently, the yield curve is very steep; so short-term rates could increase without a big impact on long-term interest rates. Excluding a sharp rise in rates, the extra yield on longer investments provides a cushion against rising rates and a higher total return than short bonds yielding less than 1%. In addition, interest rates on corporate bonds are higher than those of Treasuries and more so with longer maturities; therefore, steep spread curves provide an additional cushion should rates rise. The Federal Reserve has clearly indicated that it does not intend to raise short-term interest rates for an "extended period of time." The recent slowing of economic growth, which we expected, will likely reinforce that view. As long as the Fed keeps its anchor on short rates, the yield curve should remain steep and longer maturity corporate bonds are attractive.

**Longer maturity  
corporate bonds  
are attractive**

The U.S. equity market remains caught in a decade long trading range. The last trading range period was 1966-1982. The only identifiable areas of fundamental, secular economic growth are the developing economies, which are propelled by population expansion, modernization and relatively low labor costs that foster exports. At the same time, developing economies are more volatile and subject to liquidity and political swings; so attention to price is important.

Emerging market debt may be as attractive as emerging market equity, particularly on a risk adjusted basis, since the downside is better protected. All forms of international investments diversify dollar risk. Medium grade and below investment grade corporate credits may be attractive as alternatives to the equity markets. The attraction of commodities hinges on the outlook for global growth, particularly in Asia. Heightened volatility is likely to continue. Given the murky economic and political outlook, we remain flexible but disciplined and maintain a spending reserve, when appropriate.

**- EM Debt -  
may offer better  
downside  
protection than  
- EM Equity -**

The reserve grows when riskier assets are high priced and expectations are elevated. This can be a source for distributions and as part of portfolio rebalancing; adding to funds and managers of stocks when prices are in the lower third of the trading range, and to bonds when spreads are relatively wide.

We remain focused on allocating assets among funds and managers that have a well articulated philosophy of investing, a disciplined process and a history of long-term success net of fees and expenses: people, philosophy, process, performance and pricing.

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By Maureen Busby Oster, CFA  
MBO Cleary Advisors Inc.

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