

## US Market Watch

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### Review

Only a few days into 2012 and the start of the year already feels quite different from 2011. First of all the weather is much better; December had about 25% fewer heating degree days compared to a year ago. Second, we have far less political interference. Last year we had to deal with the Fed's inflationary QE2 program and a sharp tightening of fiscal policy in state and local budgets. This year, the Fed is merely reshuffling its portfolio and the odds are good that last year's payroll tax cut will eventually be extended for the full year. Meanwhile, the healthy business sector is finally showing the willingness to use its ability to expand and hire. In fact, there is a chance we may see a decent private sector driven pick-up in economic activity this year. Let's hope I don't have to dust off my 2011 macro theme of 'Politics vs Economics', after all this is an election year.

Financial markets ended the year 2011 in mixed mood. The large cap S&P 500 Index eked out a 1% gain to end the year up 0.7%; the small cap heavy NASDAQ fared only marginally better judging with its 1.2% gain in 2011. Corporate bond

markets, meanwhile, had a much better year. The Barclays Capital US High Yield index ended the year up 5%, investment grade bonds fared even better, up 8.4%, yet the star performer was US Treasuries, up 9.8%, despite the fact that excessive government debt is at the heart of much of the economic troubles and the political acrimony in Washington. The US dollar ended the year about flat - down 0.8% against a broad trade weighted basket of currencies and up 0.9% against the six most actively traded currencies - thanks to a strong second half performance. Here are a few bold predictions for 2012: I expect equity markets and Treasuries will reverse positions (and performance numbers). It should still be a good environment for corporate bonds and the dollar is likely to end the year notably stronger.

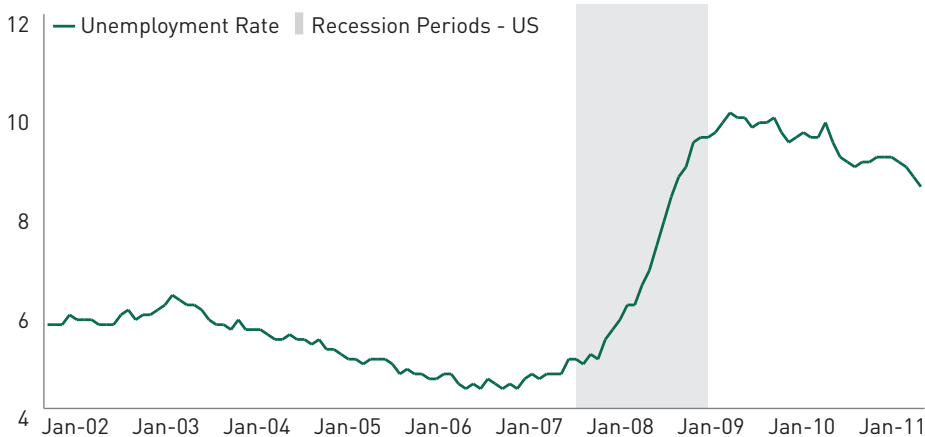
### Economy

The gradual improvement in the US economy continued through December. Both the manufacturing and service sector ISM surveys increased further last month signaling faster growth. The most recent recovery is not driven

by government stimulus, but a healthy industrial sector that is starting to gain confidence and, more importantly, starting to increase payrolls. The most recent evidence shows the pace of job creation is clearly picking up, which will offset the continued weakness in wage growth<sup>1</sup>. The rebound in Consumer Confidence has probably been the biggest surprise in the past two months. Both the Conference Board and the University of Michigan surveys have bounced back close to their post-recession highs supporting the growth in spending. The extension of the payroll tax cut has greatly reduced the risk of further fiscal tightening this year and I have raised my 2012 growth forecasts slightly from 2.1% a month ago, to 2.3%.

The immediate risks have shifted from policy errors such as premature tax increases and another round of real-income-depressing QE3, to geopolitics and a potentially sharp increase in oil prices. The saber rattling in the Persian Gulf may end up being just that. However, West Texas crude prices have jumped back above US \$100 in early January and at US \$103.22, reached the highest level since last June<sup>2</sup>. The sharp growth slowdown in the first half of last year was largely driven by a temporary inflation spike, which in turn was triggered by the Fed's QE2 asset purchase program. Another inflation spike, as a result of rising oil prices, could be equally growth-depressing. Housing remains another key trouble spot. The recent surge in home sales - new home sales were up 10% from a year ago in November, existing home sales an even better 12% - is surely encouraging. Yet, the sharp drop in home purchase applications in recent weeks suggests this may have more to do with the year-end effect than

FIGURE 1 US Employment Rate Starting To Improve More Rapidly



Source: FactSet Research Systems.

<sup>1</sup> Source: Bureau of Labor Statistics Employment Report 1/6/2012.

<sup>2</sup> Source: Bloomberg, as of 1/4/2012.

Past performance is not indicative of future results.

a sustained rebound in demand. Indeed, housing prices continue to decline, which maintains the squeeze on underwater borrowers and prevents an end to the foreclosure crisis.

## Policy

The minutes of the last Federal Open Market Committee ("FOMC") meeting of 2011 contained a surprise announcement that the Fed will start publishing policy rate path projections in addition to forecasts for GDP growth, inflation and the Unemployment Rate. The move is designed to add more transparency to the Fed's policy making however, I am not sure what analysts like myself or investors will really get out of this new policy tool. The past has shown the Fed's economists are clearly no better at predicting the future than the rest of us or, for that matter, the futures markets. In fact, I fear this move could instill a false sense of certainty about future interest rate policy and it will expose the Fed to the same risk of having to 'adjust' one's forecasts to unexpected changes in the economy. Aside from the adjustment in communication, the December FOMC statement remained biased towards further easing steps, stating the Fed "is prepared to employ its tools to promote a stronger economic recovery"; hence monetary policy will remain supportive for financial markets.

Fiscal policy is a more volatile subject. Congress just agreed on a two month extension of last year's payroll tax cut that will prevent a stronger fiscal headwind from slowing growth at the start of the year. However, it also revealed the continued inability to compromise in a system of government designed to rely on compromise. I expect further acrimonious fights over not only the payroll tax cut in the coming months, but also over the currently automatic spending cuts and tax increases in 2013. I am not looking for any further stimulus this year; President Obama's US \$447 billion jobs plan didn't go anywhere in Congress. However, one area where Congress might actually add some value this year is housing. I haven't seen concrete proposals, but a number of commentators - and our mortgage traders - believe the government may announce measures to address the still significant headwinds stemming from ongoing foreclosures and housing price declines; that would surely be good news.

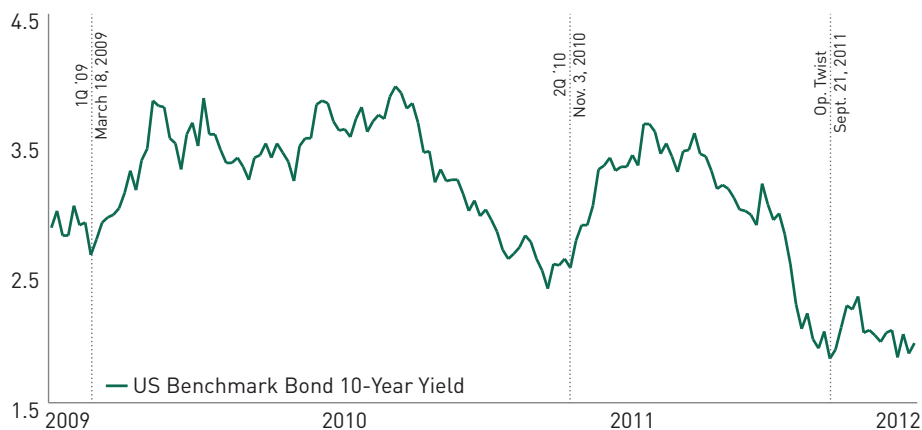
## Interest Rate Strategy

The Fed's latest move is not likely to have a significant impact on current short rates or current investor expectations. Futures markets are not pricing in a rate hike until the first quarter of 2014, a view that is confirmed by a recent survey of primary dealers; the same survey also

showed a majority of dealers is still looking for QE3. There is absolutely no debate about possible exit strategies, and 2012 may not be the year to start it. However, markets seem so heavily invested in the Fed's 'Zero-Interest-Rate' policy that the pain trade is clearly a change in the macro environment that forces the Fed to adjust forecasts and policy. Even though I disagree with the policy, we cannot forecast anything else but quasi-zero Federal Funds rates though at least 2013.

The long end of the US Treasury yield curve has been trending sideways in the past few months. Since the start October ten year Treasury yields have traded in a 30 basis point range, around a 1.98% average; and that despite significant changes in the US macro backdrop and ups and downs in the Eurozone Debt crisis. Evidently, US bond yields contain less and less information about market expectations for growth and inflation. Rather, who wants to bet against a central bank that is a significant buyer of long-term government bonds and is openly debating whether to increase its holding further. The latest decision to publish Federal Funds forecasts will only increase the forces that keep ten year Treasuries anchored around 2% irrespective of what the economy is doing. ■

FIGURE 2 US 10-Year Yields Remain Near Record Lows



Source: FactSet Research Systems.



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