



FIXED INCOME MARKET OVERVIEW

January 2012

The word transparency has, over the last few years, taken on a whole new meaning in the financial world. I always thought of transparency as seeing an object clearly, as if looking through a glass window, one that has been cleaned with Windex and is not all muddy, of course. Perhaps this is my problem. I have a deep rooted desire to look through glass windows 'clean' so that I can clearly see what is on the other side. Now transparency means: tell them something is on the other side, but don't let them see it. The Federal Reserve has made it crystal clear that they want to be transparent. So, they tell us that they are going to keep interest rates at zero until the end of 2014. Furthermore, they let all the Fed members provide us their thoughts on what the yield curve should look like. That's great! Now we have seven opinions from which to choose clarity and direction. Call me antiquated, but I enjoyed less transparency. Before, we were privileged to do our own homework, legwork, or research to determine the direction of the economy and interest rates. Now we are told what the policy will be within a very specific timeline leaving us scratching our heads trying to figure out why. What if they are incorrect? Will the Fed raise rates in order to correct their erroneous assumption? What does that do to the investor that 'assumed' the Federal Reserve has a crystal ball? If the Federal Reserve felt that a second recession was coming as a result of a foreign catastrophe, would they tell us? No! So, where is the transparency? Please, take me back to the dark ages, and we will light our own way.

Now that we have settled the transparency issue and let off some steam, let's look back to see what may lie ahead. After having lowered the federal funds rate down to zero at the end of 2008, the Fed implemented two rounds of quantitative easing and a maturity extension program (a.k.a. Operation Twist). Since the March 17-18 meeting of the FOMC, the committee slated a federal funds rate policy of zero for an "extended period." In August 2011 they 'clarified' the extended period by proclaiming mid-2013 as the possible end of the period. In January of 2012, the period was further extended 18 months. Since 2008 the Fed has essentially tried to do the following: 1) help the banking sector by lowering funding costs to zero and let them earn with the "carry trade," 2) inflate asset prices, especially stock and home prices (this one has not worked) as a means to boost spending, and 3) stimulate borrowing, especially in the housing market (refinancing), in order to boost spending. The goal was for the consumer to spend and thereby create job growth as the economy perked up. So much for a stellar plan. Not to worry, however, because although every policy that the Fed has employed meddling in the MBS market, lending to private sector indirectly via banks, holding interest rates at zero, devaluing the dollar, and debasing the



dollar via the printing press, is an inflationary Armageddon, they have the wherewithal to keep inflation contained at reasonable levels. After all, they have the ability to raise the Federal Funds rate whenever they deem inflation is on the rise. Of course inflation will not kick in until after 2014.

The media and pundits keep telling us how the economy is turning around, and growth, jobs, and security are all around the corner. Maybe this is true; however, if so, then why must we extend the zero policy another 18 months. After all, every penny that could be earned in pensioner and non-pensioner's money market accounts may just lead to some spending. We might be able to buy a whole loaf of bread instead of a roll. Well, perhaps we are not seeing something else.

Europe. A day does not go by without us wondering how this charade will be resolved. Since we have been deceived, cuckolded, and misled since early 2010, it is difficult even to imagine a solution. The reality is that Greece is bankrupt, and any future lending is not a loan, but alms. We will not even visit the ramifications of triggering the default contracts. That will be for the courts. Europe is at the brink of disaster. Portugal is knocking on the door any day now for more help. Spain's unemployment rate is at 22%. Italy, as per the Mexican president, only has a liquidity problem. It is reassuring to get this piece of news from an 'insider.' The IMF is warning us of a slowdown in the European economy. At what point does Peter stop giving to Paul? As the European banks go, so go the US banks. As a result, keeping rates low to re-enforce the US banking system appears to be a possible reason, and maybe, the only reason why the Fed is choosing to hyper-inflate the future. Whatever writing is on the wall, it appears that for the meantime, fixed income investors will remain with their backs against the wall. Stay short and earn almost zero. Go long and see the chances of a principal loss increase dramatically. Choose risk and watch principal erode before one's eyes. We remain cautious and consider our client's principal first and always. The days of earning a return will return, and having assets to invest at that time continues to be our mission. We have been given an extra 18 months of extension leeway. This extension results in an additional 13 basis points of return. This must be weighed against the risk that the Fed is wrong.