Economic and Financial Markets Review
2012 Third Quarter

2012 Q3 Highlights

- Major policy announcements and monetary actions by global central banks pumped more liquidity into struggling economies and encouraged investors, traders, and speculators to embrace more investment risk.

- The third quarter was a "risk-on" period around the world. U.S. stocks gained 5-7% during the quarter, with large caps marginally outperforming mid and small caps. Foreign stocks posted slightly higher returns of 7-8%, led by foreign small cap and emerging market stocks.

- Investment grade bonds posted gains of 1-2%, supported by continued stimulus from The Federal Reserve, while riskier high yield bonds took their cue from stocks and rose over 4%.

- In spite of elevated risks from faltering economies in the developed nations, fragile financial systems, and the impending "fiscal cliff" of tax increases and spending cuts in the U.S. on January 1, 2013, the momentum of the financial markets is clearly higher given the renewed commitment by global central banks to continue their stimulative monetary policies.

2012 Q3 Investment Recap

After a short-lived pullback in the second quarter, stocks surged upward from the lows in early June to post year-to-date returns in the mid-teens. The catalyst for the rally in stocks and other risk assets over the past few months has been global central bank monetary policy, with markets reacting positively to policymakers' signals, and subsequent announcements, of additional liquidity and market support by the European Central Bank and the U.S. Federal Reserve (the "Fed").

With the exception of the U.S. housing market, which is showing increasing signs of improvement nearly six years after the housing bubble popped, and accelerating activity in the U.S. energy industry as a result of recent oil discoveries in shale formations such as the Bakken in North Dakota and the Eagle Ford in south Texas, the bulk of the economic news was not positive during the quarter. While unemployment claims continue their modest decline from the 2009 highs, U.S. employment numbers highlighted the disappointments. However, the stock market's mindset seemed to be that, "bad news is actually good news because it means the Fed will step in with even more aggressive intervention, which will be a further boost for risk-taking."

The ECB: 'OMT!'

Throughout July and August, European Central Bank (ECB) President Mario Draghi, with the support of other Eurozone political leaders, communicated that the ECB was preparing to take decisive action to eliminate the risk of a Eurozone break-up and financial crisis. On July 26, 2012, Draghi said, "*Within our mandate,* ***the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.***" This policy signaling culminated in the ECB's announcement on September 6, 2012 of a major new policy dubbed "outright monetary

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transactions," or OMTs. On the same date, Draghi also declared, "The euro is irreversible," meaning that it would never be allowed to break apart.

Under the OMT program, the ECB committed to potentially unlimited purchases of distressed Eurozone government bonds (e.g., from Spain or Italy) with maturities of up to three years. However, it also said such purchases would be conditional on the target country's government formally requesting assistance and also committing to additional fiscal controls (austerity) and structural economic reforms, under external oversight. That is, the government must agree to give up some sovereignty. The ECB also said it could stop its bond purchases if the target country breaks its commitments. Finally, the ECB said it will "sterilize" its bond purchases by removing an equivalent amount of liquidity from the financial system. This provision was likely included in order to preempt criticism that the OMTs are monetizing the bad debt, i.e., "printing money," which raises fears in some camps of a repeat of a hyperinflationary period similar to the Weimar Republic in Germany during the 1920s.

OMTs are significant because it is the first time the ECB has made an *open-ended commitment* in terms of both the amount of government bonds it might buy on the secondary markets and the time frame over which the policy will be active. The ECB's words and actions had the desired effect of sharply reducing yields on Spanish and Italian government debt, and also giving a strong boost to European stocks.

The OMTs appear to have reduced the perceived and actual risk of a systemic debt crisis in the Eurozone, at least over the nearer-term. But there remain many unanswered questions and unknowns with regard to the actual implementation of the OMTs (let alone their longer-term effectiveness), not the least of which is whether and when Spain will actually ask for formal assistance and agree to the necessary conditions. Moreover, the credibility of the ECB's commitment to enforcing conditionality under the OMT program is questionable. A *Financial Times* editorial put it this way:

> 'This commitment, while welcome, does not eliminate the risk of moral hazard. Mr. Draghi may claim that the ECB will stop buying the bonds of countries which are not compliant with their agreed programmes. But doing so after the central bank has stuffed itself with a country's bonds is like putting a gun to one's own head and threatening to pull the trigger.'

In other words, doing so would cause yields to spike back up and hasten a Eurozone debt crisis. On the other hand, if the ECB continued to buy bonds after a country failed to hold up its end of the conditionality bargain, it would almost surely intensify opposition to the program by Germany, whose central bank was the one dissenting vote against the OMTs, and other countries. This would potentially lead to renewed fears of euro "reversibility"—precisely what the OMTs are meant to prevent. So the OMTs buy some more time for Eurozone political leaders to try to work toward a long-lasting solution. It may be more meaningful than the previous kicking-the-can-down-the-road actions of the ECB, but obviously, it still does not "solve" the structural problems threatening the existence of the Eurozone, which include:

- Competitive imbalances between the Northern Europe and Southern Europe economies;
- Unsustainable debt/deficit issues facing Southern Europe;

- The necessity of further political, fiscal, and regulatory integration amount the Eurozone countries in order to create the conditions necessary for a sustainable monetary union; and
- Huge challenges to achieving such integration given the conflicting incentives and the significant economic/cultural/political differences across Eurozone member countries.

Martin Wolfe, the respected economics columnist for the *Financial Times*, also wrote:

> 'The ECB has done what it can, given the politics.... But the risks of a breakup cannot be eliminated. For these to disappear, citizens of debtor countries must see a credible path to growth, while citizens of creditor countries must believe they are not throwing money down a bottomless pit. What the ECB has done is win some time. It has not won the game.'

There remains a significant likelihood that the Eurozone will not survive this crisis intact and a lesser, but still material, probability that the breakup will not be orderly, but instead chaotic and disorderly, resulting in a major shock to the global financial system and markets. Even if there is a Eurozone breakup, the timing remains highly uncertain. The OMTs appear to have at least extended the potential time frame before a breakup, if not substantially reduced the risk of that ultimate outcome.

The Fed: 'QE Infinity and Beyond!'

After foreshadowing further action several weeks earlier, Fed chairman Ben Bernanke made yet another major monetary policy announcement on September 13, 2012:

1. The Fed initiated a new program of quantitative easing, "QE3," saying it would buy $40 billion per month of government agency mortgage-backed securities. An important distinction compared to QE1 and QE2 is that QE3 is *open-ended* (similar to OMTs), with no predefined end-point in terms of its duration or magnitude. This led some commentators to refer to it as "QE Infinity" or "QEternity".

2. The Fed said it would continue its Operation Twist program through the end of 2012, buying $45 billion per month of longer-term Treasury bonds and selling shorter-term Treasury securities. This program has been in place since September 2011 in an attempt to lower longer-term interest rates.

3. The Fed emphasized that QE3 would be tied to conditions in the labor market, specifically the unemployment rate. It also said if there isn't substantial improvement in unemployment, it would take additional actions beyond buying mortgage-backed securities. Specifically, the Fed stated, "If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability." (This targeting of the unemployment rate in their policy decisions potentially leaves the Fed in a vulnerable position since it cannot directly affect the decisions of employer to hire workers and because other government policies may work at cross purposes toward the Fed's goal of increasing employment.)

4. The Fed attempted to further influence market expectations regarding its commitment to reflation (boosting asset prices and avoiding a deflation similar to The Great Depression in the U.S. in the

1930s), and perhaps marked the initiation of a new inflationary monetary regime, stating: "To support continued progress toward maximum employment and price stability, *the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens*."

5. The Fed also said it expects to keep the federal funds rate at exceptionally low levels (0%–0.25%) at least through mid-2015. Previously their expectation was through the end of 2014.

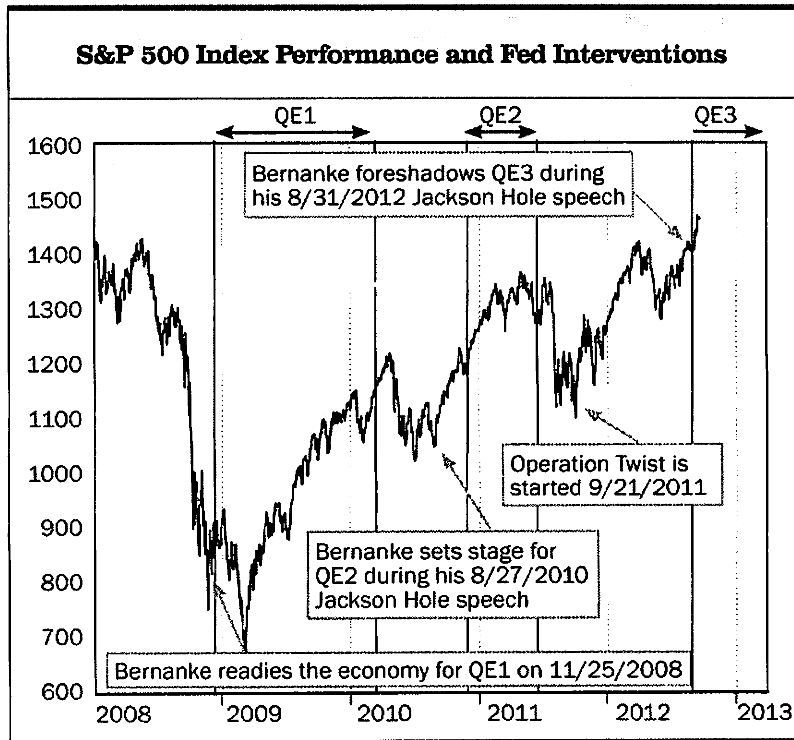
These are significant changes to Fed policy. Clearly Mr. Bernanke has fired his biggest "bazooka" yet in an attempt to keep the modest U.S. economic recovery from stalling. One well regarded economist, David Rosenberg, formerly the chief economist of a major Wall Street firm, called them "nothing short of radical." There is already ample liquidity in the U.S. banking system, with $1.5 trillion in excess bank reserves sitting idle at the Federal Reserve as a result of the previous QE1 and QE2 programs. U.S. corporations are also flush with more than $1.7 trillion in cash on their balance sheets. The bottom line is that there is plenty of credit potentially available if lenders are willing to lend and borrowers want to borrow. So, the recent Fed moves are clearly not needed for liquidity reasons.

Instead, Mr. Bernanke and the Fed seem to be sending an extremely strong signal that they have no intention of pulling back on their aggressively accommodative monetary policy and that they view unemployment as a significantly greater risk than inflation. (Remember that the Fed has a so-called dual mandate to promote maximum employment, along with stable prices.) As Mr. Bernanke stated with the prior two rounds of QE, the goal is to depress interest rates even more in order to encourage (or push) investors further out on the risk spectrum, causing increased inflation in asset prices, such as the stock market and housing, with the hope that the positive "wealth effect" will stimulate consumer spending and ultimately business investment and job creation. That's the theory. Whether it will actually lead to any significant real economic impact is the subject of debate among economists.

But there may be more significance to the policy than just an attempt to create a wealth-effect stimulus. Mohamed El-Erian, CEO and co-CIO of PIMCO, recently wrote that the United States might now be experiencing "a 'reverse Volcker moment' in which low and stable inflation gets subordinated to other economic objectives." In other words, this may be the beginning of central bank policy regime change that reverses the expectations that have been in place since the early 1980s when Fed chairman Paul Volcker crushed inflation and reset inflation expectations by raising interest rates even as the economy experienced a severe recession (the federal funds rate peaked at 19% in 1981). Mr. El-Erian also notes, as have many others, that given the U.S. debt burden and sluggish growth prospects, it is tempting for governments to resort to "somewhat higher" inflation as a means to help deleverage. *New York Times* Op-Ed columnist and Princeton University economics professor Paul Krugman, has said he believes this was an explicit (and salutary) aim of the new policy. As it turned out, market-based measures of inflation expectations did spike higher after the Fed announcement.

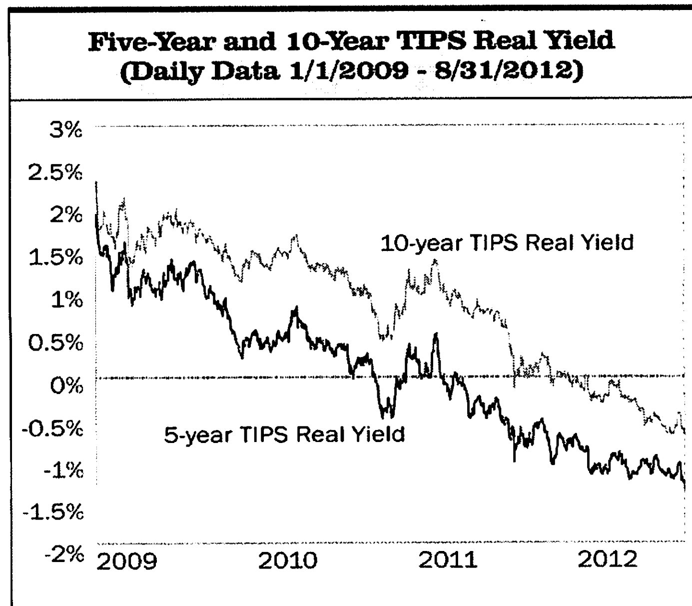
Strategy and Conclusion

We do expect these policy actions and the markets' reaction to them to impact our investment managers' assessments of relative risks and returns across their investment universe, particularly for bond fund managers. While the central bank actions reviewed above may continue to encourage investor risk-taking and push stock prices higher, as the Fed would like to see and has been the case with the Fed's prior interventions (see chart below), we are not going to play that speculative game. It doesn't fit with our investment philosophy and process, which is focused on evaluating asset class fundamentals and valuations over a longer-term time horizon while being cognizant of the downside investment risks. For the time being, we are sticking with our emphasis on high quality, "all-weather" investments. If stock prices move increasingly higher, our view would likely be that the return vs. risk equation is getting worse (all other things being equal) and we would likely reduce the level of equity-risk in our portfolios.



Correlation is not causation, but stocks have rallied during periods of Fed intervention since late 2008. Source: Yahoo! Finance. Data as of 21 September 2012.

We are, however, spending time thinking about scenarios where the inflation rate exceeds the yield on Treasury bonds for an extended period of time – i.e. negative "real yields." As shown in the chart at right, this is currently the situation across much of the yield curve for Treasury Inflation Protected Securities (TIPS) as well as nominal Treasury bonds. The Fed's QE3 suggests they would like this environment to continue. (See the discussion of the concept of "financial repression" in our 2012 Q1 review.) One of the key benefits of negative real yields to the government (and all debtors in general) is that it eases the burden of debt deleveraging, but it penalizes savers and investors by robbing them of purchasing power.



Negative TIPS yields reflect the current environment of extremely low Treasury yields relative to expected inflation. Source: U.S. Treasury.

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Index Returns for the Period Ending 9/30/2012

Editorial Note: The column of 5 Year Annualized Returns shows the performance of the major indices from just before the all-time stock market highs in early October, 2007, through the financial crisis and "Great Recession" of 2008-2009, and the ensuing recovery that is continuing today. All of the major asset classes have posted positive five year annualized returns except foreign stocks and commodities. The column of 10 Year Annualized Returns shows the performance of the indices from the bear market lows in the fall of 2002. Here is numerical evidence that it pays to maintain a long-term perspective!

	2012		Average Annualized Returns				
Equities and Equity Alternatives	**Q3**	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**10 Yrs**	**15 Yrs**
US Stocks							
S&P 500 Index (US Large Caps)	6.4	16.4	30.2	13.2	1.1	8.0	4.7
S&P Mid Cap 400 Index (US Mid Caps)	5.4	13.8	28.5	14.3	3.8	10.8	8.9
S&P Small Cap 600 Index (US Small Caps)	5.4	13.8	33.4	15.1	3.3	10.7	7.3
Russell 1000 Index (US Large and Mid Caps)	6.3	16.3	30.1	13.3	1.2	8.4	5.0
Russell Mid Cap Index (US Mid Caps)	5.6	14.0	28.0	14.3	2.2	11.2	7.6
Russell 2000 Index (US Small Caps)	5.3	14.2	31.9	13.0	2.2	10.2	5.5
Russell 3000 Index (98% of US Stock Market)	6.2	16.1	30.2	13.3	1.3	8.5	5.0
Foreign Stocks							
MSCI EAFE Index (Foreign Large Caps - Developed Markets)	6.9	10.1	13.8	2.1	(5.2)	8.2	3.4
MSCI EAFE Small Cap Index (Foreign Small Caps)	7.9	13.2	12.6	4.8	(3.0)	11.2	n/a
MSCI Emerging Markets Index (Foreign Emerging Markets)	7.7	12.0	16.9	5.6	(1.3)	17.0	n/a
Equity Alternatives							
FTSE NAREIT Equity REIT Index (US Real Estate)	1.0	16.1	33.8	20.7	2.3	11.5	8.8
Dow Jones UBS Commodity Index (Commodities)	9.7	5.6	6.0	5.3	(3.0)	5.2	4.0
Fixed Income and Cash							
High Quality Taxable Bonds							
Barcap 1-5 Year Govt/Credit Index (US Short-Term Bonds)	0.9	2.0	2.5	3.2	4.3	3.9	5.0
Barcap Aggregate Bond Index (US Intermediate-Term Bonds)	1.6	4.0	5.2	6.2	6.5	5.3	6.2
Barcap US TIPS Index (US Inflation Indexed Bonds)	2.1	6.3	9.1	9.3	7.9	6.6	7.4
High Quality Tax-Exempt Bonds							
Barcap Municipal Bond Index (US Tax-Exempt Bonds)	2.3	6.1	8.3	6.0	6.1	5.0	5.6
Low Quality Taxable Bonds							
Credit Suisse High Yield Index (US High Yield Bonds)	4.3	11.2	17.9	12.6	8.6	10.5	7.1
Cash & Equivalents							
3 Month US Treasury Bill (Cash)	0.0	0.1	0.1	0.1	0.6	1.8	2.7
US Inflation (Urban Consumers)							
US Consumer Price Index (US Urban Inflation as of 8/31/12)	0.7	1.4	1.7	2.2	2.1	2.5	2.4

The index data shown represent past performance, which is not a guarantee or indicator of future returns.
You cannot invest directly in an index. Investing involves expenses which are not reflected in the above return figures.
Diversification does not assure a profit nor protect against losses in a declining financial market environment.
The above data were gathered from sources known to be very reliable, however data accuracy is not guaranteed.