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# Financial Markets Perspective

## A Tale of Two Markets

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At the start of 2011 the S&P 500 stood at 1258, the Bush tax cuts didn't expire and consumers were given an extended Christmas present in the form of a temporary reduction in the payroll tax. In the face of stubbornly high unemployment, a series of catastrophic weather events and Europe's ongoing financial crisis, investors found themselves expecting a less profitable year after double-digit stock returns in 2009 and 2010. And that is exactly what they got--the S&P 500 finished the year flat at 1258 not including dividends. Long-term investors who don't pay much attention to day-to-day or month-to-month swings in the market would say: "That was a ho-hum year." Unfortunately, the behavior of stock markets during 2011 was far from dull and whipsawed investors violently particularly in the latter half as volatility hit record levels. This erraticism sent many investors – both professional and retail – to the sidelines. While the U.S. markets experienced an overall slightly positive return, foreign markets were pummeled – especially those in Europe where financial turmoil in sovereign debt markets in the smaller peripheral countries (coined unflatteringly the PIGS for Portugal, Ireland, Greece and Spain) threatened to drag down the larger economies. Some commentators saw these developments in a humorous light such as David Wessel who recently wrote in the Wall Street Journal: "A Greek, an Italian and a Spaniard walk into a bar…Who pays? The German." That joke pretty much tells the story of the economic situation in Europe.

To quell the financial crisis, the European Central Bank (ECB) provided €489 billion in three-year loans to Eurozone banks last month, averting a potential credit crunch and reassuring investors that banks will be able to fund themselves in the coming months. Greece must redeem a €14+ billion bond on March 20th. Almost all analysts agree it will be unable to do so unless its official creditors approve a second €130 billion bail-out package and unless a deal is agreed to cut the country's debt by imposing a 50 per cent haircut on €206 billion of privately held bonds. Greece has already received about €73 billion from the first bail-out package of €110 billion that was financed by the European Union and the International Monetary Fund. So the first three months of this year will be critical to watch and will continue to test the market's nerve.

Italy's banks sharply increased their use of European Central Bank loans to more than €200 billion last month, leaving the country accounting for almost a quarter of total liquidity supplied by the euro's monetary guardian. Moreover, the surge in borrowing from the ECB

highlighted tensions in Italy's financial system and indicated its banks had drawn heavily on an ECB pre-Christmas offer of unlimited three-year loans. ECB lending to Italian banks reached €210 billion at the end of December, up from €153 billion a month earlier and the highest on record. The good news is that Italian tax officials under the new government of Mario Monti uncovered billions of undeclared revenue by both individuals and businesses earlier this month. After a raid on one of Italy's most exclusive ski resorts, the authorities reported that 66% of the country's 4 million taxpayers claimed a gross annual income of less than €30,000. Despite their apparently breadline salaries, 188,000 own a high-powered car such as a Maserati, Ferrari or Porsche, 42,000 own yachts and 600 commute by private plane to work. Now that Mr. Berlusconi is out of office (he condoned tax dodging—note his multi-million dollar villa on the Emerald Coast of Sardinia), tax officials will be increasing their crackdowns to include summer resorts in order to recoup the estimated €120 billion lost to the treasury each year. These developments shall be entertaining to watch but, more importantly, highlight the fact the new government is serious about economic reforms that include tax increases and spending cuts.

Spain is not much better off and announced that this year's budget deficit is likely to reach 8 per cent of gross domestic product, much higher than expected and a full 2 percentage points, or €20 billion, above the target agreed with the European Union. Under Mariano Rajoy, the Popular party prime minister who ousted the Socialists in the November general election, the government says it is maintaining Spain's commitment to cut its budget deficit to 4.4 per cent of gross domestic product this year, as agreed with the European Union. Spain's autonomous regional governments accounted for most of the overshoot in the 2011 public sector budget deficit and Madrid is therefore blaming them for emergency tax increases. The central government is now ready to implement legal measures to curb the regions' spending after years of lax oversight. A new financial straitjacket imposed by the center will be resisted by the independt-minded leaders of Catalonia, an economy the size of Portugal. But these measures are only one part of an economic reform agenda that can be described as "aggressive" and that the new government wants to enact in its first 100 days. How can the government promote growth and create jobs in the midst of a severe austerity program? Stay tuned.

Last year, domestic equity markets did not respond well to the on-again off-again crises in Europe and continued bickering in Washington. However, the first three months of 2011 actually saw most indices post a gain. There was never a better year to use the adage "Sell in May and Go Away". After their April high, stocks entered an extremely volatile period that was exacerbated by weaker than expected GDP growth in May, controversy over the raising of the debt ceiling in Washington with ultimate resolution in July, and an S&P downgrade of the USA from AAA to AA+ in August sending the S&P to one of its lowest levels of the year. After bottoming in early October, stocks rallied on better than expected economic news and finished

out the year flat. (Including reinvested dividends, the index actually had a gain of 2.1% for 2011). After two years of above-average returns in 2009 and 2010, the market took a breather.

The recovery in U.S. equity markets late in the year can be attributed to the fact that the ECB acted as a lender of last resort for individual members of the European Union. Since there is no central fiscal authority in Europe like we have in the United States, the ECB had to be the entity to rescue individual countries. The ECB became Europe's "Federal Reserve Bank" in essence by writing a check to keep their economies intact. Remember that the Federal Reserve took similar action in 2008 when it purchased over a trillion dollars in mortgage backed securities that were considered toxic by the investment community. Without that purchase, the financial system would have never recovered.

These two steps by the Federal Reserve and the European Central Bank have taken the global financial system to a new level of functionality. When countries operated under a monetary system that relied on a commodity such as gold to back that system, there was an inherent weakness: the issuance of currency was constrained by the availability of gold. When President Nixon took the U.S. off the gold standard in August of 1971, he freed the financial management of the country from being tied to "Fort Knox." This flexibility has given central banks the ability to deal with financial crises without being constrained by some arbitrary issuance of currency. While there may be an element of inflation risk from the exercise of this power beyond reasonable bounds, the use of this control to rescue economies from financial catastrophe is a true asset that cannot be measured.

Most of the financial community does not fully recognize the opportunities presented by this power. The general opinion of both economists and politicians is that federal deficits and the national debt are a huge liability of the federal government that must be repaid at great cost to the economy. They see the possibility of a U.S. bankruptcy and failures of government entities such as the Social Security system if payments on the national debt are not made. Since the federal government has the power to print money without limitation, it can write the check to Social Security recipients or pay off maturing government debt as necessary. There is no constraint on the federal government's ability to make such payments. The goal of federal government, given this power, is to manage the economy to maximize output and employment while keeping inflation under control.

One problem governments around the globe have is that they cling to the outdated theory about how they manage their economies to maximize output and employment. To deal with the problems associated with budget deficits, European countries are implementing massive austerity programs that consist of policies that increase taxes and lower government spending. These policies are anti-growth and are likely to lead to higher budget deficits, not lower. On our

shores, politicians tell us that our grandchildren will have to pay for the government's profligate spending. They tell us that Social Security will run out of money in the not-too-distant future. As a result of these claims, the support for increased taxes and reduced government spending is gaining in Congress. To the extent that support for such austerity measures produces higher tax rates as advocated by one political group or lower government spending as advocated by select members of another, the successes of central bank intervention in avoiding catastrophe could be squandered.

Now that we have entered 2012, the U.S. has been fortunate, in one sense, that austerity policies have not been implemented due to the political stalemate. Similarly, the Congressional agreement to raise the budget deficit subject to major spending cuts doesn't take effect until 2013 thus postponing the potential fall in demand from reductions in government spending. Unfortunately such gridlock does not exist in Europe where one country after another is implementing austerity measures to resolve budget deficit problems.

Greece is the perfect example of what we call "austerity economics". The EU required spending cuts and tax increases to close the country's budget deficit. As a result, the Greek economy contracted by 7% in 2010 and another 5% through June of 2011 (the latest data available). As a result, tax revenues last year fell by €2 billion or 8.3% versus an expected increase of €3.3 billion. Social spending rose as unemployment jumped from 9% to 16%. Government debt has become an even greater part of a shrinking economy—a fact that makes a Greek default even more likely.

Other European countries are also headed down this path. Italy increased its value-added tax to 21% and, as stated, is aggressively cracking down on tax evasion and may implement a wealth tax. Last year, the French raised taxes on wealth, gifts and inheritances. Spain is reinstating a wealth tax that was suspended in 2008 on over 160,000 individuals. The same mentality seems to permeate the governing elite in the U.S. The battle over the extension of the payroll tax cut is focused on only one year—hardly a confidence-builder for businesses.

So far we have discussed two divergent stories: (1) the ho-hum returns of U.S. stocks versus the steep losses posted by foreign stocks and (2) the relatively calm first half of 2011 followed up by record levels of volatility during the last six months of the year. There is a third "tale of two markets": the performance of stocks versus bonds.

At the beginning of 2011, many professional investors fell into the trap of believing that inflation would go up that would send bond prices down. One of the great bond investors of our time, Bill Gross of Pacific Investment Management Company (PIMCO), said on February 15th that he was getting out of government bonds. By February 28th, he had sold all of his fund's holdings and the yield on the 10-year Treasury note was 3.42%. By December 31st, bonds had

rallied sending the yield on the 10-year Treasury note down to 1.88%!  Another good benchmark for gauging the performance of bonds last year is the Barclay's 20+ Year Treasury Bond Fund. At the end of 2011, the yield on this fund was 2.96% but the total return of this exchange-traded fund was a whopping 33.6%! Investors who saw a weak economy and the Federal Reserve intent on maintaining monetary stimulus experienced a return that exceeded the best return on stock portfolios.

For 2012, we are becoming less defensive in the face of continued strong gains in corporate profitability and a buildup in corporate wealth. Many corporations continue to increase dividends as last year's data shows an increase of more than $50 billion, up almost 90% from 2010 levels. Moreover, corporations still have record amounts of cash on their balance sheets ($2 trillion), which could lead to shareholder-friendly moves including share buybacks, dividend increases, and mergers and acquisitions. Lastly, violent swings in U.S. stocks last year kept many investors sidelined and underinvested in domestic equities. Continued favorable news will likely bring these investors back into the market.

The major near-term uncertainty will be on the fiscal policy front and could result in a very sizable tightening of fiscal policy in 2013, depending on the outcome of the Super Committee deliberations and the fate of the Bush era tax cuts (which are slated to expire at the end of 2012). Obviously, the election outcome will be an important determining factor, but this means that business and consumer caution tied to policy uncertainty could continue to plague the U.S. economy for quite some time.

Fiscal policy gridlock remains an important risk for 2012 and could remain as a major overhanging source of uncertainty at least through the November 2012 elections. As a result, we will continue to navigate the financial markets while being sensitive to any developments that could negatively impact the political and/or economic situation in the U.S. and abroad. European pressures will continue to weigh on the larger world as the European Union seeks assistance. Unfortunately, several important countries face elections or changes in leadership that will make it difficult for them to focus on diplomacy. There are presidential elections in the U.S., France and Russia—and China's top leadership will also be reshuffled near the end of 2012. The big debate will continue to be over the role of government in the economy.