

Monthly Portfolio Commentary



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The second quarter got off to a strong start, with stocks and bonds around the globe enjoying good returns in April (see benchmark returns table at right). U.S. stocks generally saw gains of about 3% for the month, thanks in part to good earnings reports, with growth outperforming value. Year-to-date gains for U.S. stocks are now approaching double digits. Developed-market foreign stocks gained over 5% in April, while emerging-markets stocks tacked on 3.5%. Bonds also did well, with high-quality intermediate-term U.S. bonds gaining 1.3%, and developed-market foreign government bonds gaining over 3% for the month.

Investment Team Q&A

We regularly use a question-and-answer format to address questions about our investment views and current strategy. This format permits us to address a range of different topics and allows readers to focus on areas that are of interest to them. This Q&A piece represents the outlook of our investment team and tackles questions received during the quarter.

The end of QE2 in June, coupled with the questionable financial situation of many banks, could at the least have a significant effect in the short term. Can you comment on what you believe are the most likely and more bearish scenarios?

There is plenty of conjecture about what will happen when QE2, the program in which the Fed in effect “prints” money electronically in order to buy Treasuries and other bonds, ends. One prominent example is PIMCO’s view that the end of QE2 will mark the departure of a huge source of demand for Treasuries and that therefore Treasury yields will rise.

The opposite view is expressed by Doubleline’s Jeffrey Gundlach, who argues that the end of QE2 will lead to falling Treasury yields, which is what happened when QE1 ended, because the market will view the end of QE2 as a deflationary force.

So there you have two of the most successful fixed-income investors predicting exactly opposite outcomes. We wouldn’t make a big portfolio bet on one or the other outcome. As we’ve been saying for a long time now, we are in an unprecedented environment as a result of the aftermath of the financial crisis, with fiscal and monetary policies that have uncertain and unintended consequences and that can be exacerbated and complicated by U.S. political and global geopolitical wild cards.

All the uncertainty means we don’t have a high degree of confidence in predicting any particular short-term outcome when QE2 ends (in general, we don’t have much confidence in short-term market predictions period). We do believe that the markets are probably already in the process of digesting and discounting the various possible outcomes because the end of QE2 has been clearly telegraphed and it is now only a couple months away, which is within the market’s normal discounting horizon.

As is usually the case, the consensus view of what will happen when QE2 ends should be reflected in the markets before it actually happens. That is almost certain to be the case with this event. Having

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said that, we can offer the observation that since the introduction of QE2 appears to have been hugely beneficial to risk assets, including equities, it seems logical to expect that the end of QE2 will be at least a marginal negative for most risk assets. Though not driven by this observation, our strategies have had a defensive bias for a while now relative to their benchmarks, because from a broad macro perspective we believe the economy still faces significant headwinds to growth, and our range of expected returns for the stock market doesn't warrant taking too much risk.

Longer term, over a five-year horizon, we believe U.S. interest rates are most likely to be higher than they are now, perhaps several hundred basis points higher. While our primary focus is on longer-term outcomes, we also assess downside risk from a shorter-term perspective. If the end of QE2 leads to fears within the Federal Reserve that the economy is tipping back towards deflation, they might initiate QE3 (this was the case with QE2, which followed the end of QE1 only seven months later). A deflation scare of this type may be the most bearish short-term outcome resulting from the end of QE2. That might cause a spike in global risk aversion, a sharp drop in Treasury rates (as investors flee to the perceived safety of Treasury bonds), and a sharp rise in the dollar, in particular relative to emerging-market currencies. We will continue to monitor the impact of QE2 ending on interest rates and will make adjustments as warranted.

There are many different measures of inflation that are commonly discussed: core consumer price index (CPI); headline consumer price index (CPI), which includes food and energy; and personal consumer expenditures (PCE). How do you evaluate the different types of inflation in your scenario analysis and investment decisions?

Note: The latest CPI reading was a 2.7% annual increase from a year ago. The core CPI only rose 1.2% from a year earlier. The core PCE is below 1%, while the headline PCE is under 2%.

First, we don't view inflation as a significant near-term risk. This is because of the economic headwinds caused by deleveraging which, no matter how you slice it (whether through spending cuts or tax increases), will be a drag on growth, at least over the short to medium term. And given the high unemployment and slack in the U.S. economy, demand-driven and wage-push inflation are not significant risks at this time in our view.

While commodity and energy prices have been rising strongly, wages have been stagnant (hourly wages increased less than 2% over the past year), so we don't think a wage-price inflationary spiral, as happened in the 1970s, is at all likely. Instead, we'd view rising commodity prices as being another drag on consumption and growth and therefore ultimately contractionary—effectively a tax on consumer spending. Paying more for necessities like food and energy leaves less money to spend on discretionary goods and services. For example, we've seen various economists state that if oil prices were to move up to around \$150 and stay there, it would probably trigger a recession in the United States. So, a sharp spike in energy inflation might actually weaken the case for core inflation.

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However, inflation expectations have moved higher in the past few months, as measured by breakeven rates between TIPS and nominal Treasuries, for example. And, while the most recent University of Michigan survey of inflation expectations for the next five to 10 years dropped a bit in April (to 2.9%, from a three-year high in March), it remains to be seen whether that was a one-month blip or the beginning of a downward or stabilizing trend. In any case, inflation perceptions and expectations can drive reality and become self-fulfilling. QE2 has not generated any significant core inflation because the money multiplier (M2 money supply divided by the monetary base) has fallen, so all that Fed liquidity has not made its way into the real economy. Basically, banks aren't lending the increase in reserves created from the Fed's purchases of Treasuries—excess reserves in the banking system now amount to \$1.4 trillion, up from around \$1.1 trillion prior to QE2. (And, that's up from only around \$2.5 billion in excess reserves prior to the financial crisis of 2008.)



But, if it is believed that the Fed will allow inflation to get out of control, then those expectations can generate actual inflation as people start to act on their inflationary assumptions, e.g., producers raising the prices of their finished goods and workers demanding wage increases. However, given the slack in the labor markets and weak consumer demand, it will be difficult for either price increases or higher wage demands to gain any traction.

However, medium- to long- term we do see a risk of higher inflation accompanied by a depreciating dollar as that is one politically acceptable method of reducing the real burden of paying off the country's debt. We also worry about the Fed's ability to successfully exit from their unprecedented monetary policies and think that, if anything, they will have a bias towards keeping policy too loose for too long in order to avoid triggering another deflation scare. This may lead to unexpected inflation. (Of course, some argue that this is what is already happening and that the Fed should end QE2 immediately and start raising rates. We are not in that camp.)

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How will we know if the economic recovery is self-sustaining?

The short and honest answer is that we probably won't know until some time after the fact. Even if, based on our research, we come to believe the recovery has become self-sustaining, our conviction level is unlikely to be particularly high, given all of the uncertainties and the multiple, interacting, dynamic variables involved with macroeconomic forecasting. As we've said many times in the past, even professional economists who spend all their time trying to forecast this stuff seem to get it wrong more often than they get it right.

But, we can try to provide greater context for how we think about this and some of the key variables we are monitoring. By definition, for the economic recovery to be "self-sustaining" it would have to be independent of government fiscal and monetary stimulus.

In terms of monetary policy, we'd need to see policy interest rates (e.g., the Fed funds rate) start to "normalize" at levels consistent with long-term real economic growth, rather than being pinned at essentially zero. Obviously, prior to the Fed raising rates, quantitative easing would end. And, at some point after the end of QE, the Fed would rescind the statement that says, "Economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period." (Emphasis added.) This would be a signal that they would likely be raising rates in the near future. In sum, we'd want to at least see that the Fed is acting like it believes the private economy can stand on its own without the huge monetary stimulus.

In terms of when the Fed might start the process of normalizing monetary policy, they obviously remain very focused on unemployment (as well as inflation). In March 2011, Ben Bernanke said, "Until we see a sustained period of stronger job creation, we cannot consider the recovery to be truly established." (Emphasis added.) Ned Davis Research interprets this to mean that the Fed would likely need to at least see the unemployment rate falling below 8% before it would consider raising interest rates. Ned Davis Research's best guess is that the Fed won't start raising rates until the spring of 2012.

On the fiscal policy side, we obviously have a huge debt and deficit problem. There seems to be some political will to cut spending and also possibly raise taxes in order to reduce the deficit. But, no matter how it's done, reducing the deficit will be a headwind to growth and sustainable recovery at least in the short-to-medium term. However, we probably wouldn't consider any recovery truly sustainable in the longer term unless and until the country has made credible and sustainable progress toward significant debt and deficit reduction. For example, PIMCO's Bill Gross writes that in order for the U.S. economy to achieve what they call "escape velocity," national savings (both the public and private sectors) need to grow in line with the overall economy. But the biggest impediment to achieving this goal is the persistent U.S. fiscal deficit. Gross also argues that, "A strong sign that the U.S. is making progress toward sustainable growth would be for investment to expand as a share of the economy, but companies are holding back as they assess a range of risk factors that cloud the global macroeconomic outlook."

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Households also probably have to further reduce debt levels before the stage can be set for sustainable long-term growth in consumer spending, although progress has been made there, unlike on the federal government side.

Improvement in the housing market and a big reduction in the huge overhang of housing inventory would also likely be a necessary element for, and evidence of, a sustainable recovery. BCA Research estimates that the existing and shadow inventory of unsold homes is at least four million above its long-term average, which is equivalent to about 18 months of excess supply given current sales rates of new and existing homes. So, BCA expects further home-price declines with the market not stabilizing until sometime next year.

These are some of the factors we'd look for to gain confidence in a sustainable recovery. But, again, it is unlikely that we will identify evidence that the economy has entered a self-sustaining recovery and then reach a high-conviction belief in that any sooner than the "market" does. But, as we've also emphasized, the success of our investment process does not depend on us making such macro calls.

With small-cap valuations historically high by most measures relative to large caps, is there any reason to think that this historical relationship might be different going forward? Are there other ways of evaluating small-cap performance potential?

We have not found reasons to believe that the relationship between large-cap and small-cap valuations should be different going forward. There are a number of possible metrics to evaluate the attractiveness of large caps versus small caps, including length of leadership, momentum, and cyclical considerations. We've seen momentum-based approaches that have argued in favor of small caps in recent years, despite their unattractive relative valuations, but we are unwilling to base investment decisions on shorter-term factors like momentum given our lack of confidence that we can get this right (though we do monitor these approaches and do so with an open mind). Our valuation-driven approach takes a longer-term view and is based on confidence that underlying valuations eventually normalize.

Right now, relying primarily on various valuation metrics, large caps look universally attractive, regardless of whether you look at market indexes like we do or whether you look at bottom-up company fundamentals. With valuation as our primary consideration, we continue to favor large caps over small caps and our investment strategies reflect this.

How do you think a rising rate environment will impact muni bonds?

Despite all of the uncertainty in the municipal bond market around credit risk, investors should remember the basic fact that rising interest rates hurt bonds, including munis.

One way we think about muni performance with respect to interest rates is to look at the yield ratio of munis relative to a comparable maturity Treasury. Typically, muni yields are lower than Treasury

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yields because munis are not subject to income tax. For illustrative purposes, in the 10-year part of the curve, muni yields have, on average, been 80% of the Treasury yield. But today, muni bonds along most of the yield curve are offering yields well above the historical average; and in some maturities, muni yields are in line with, or even above, U.S. Treasury yields. For example, the 10-year muni yield is currently 3.15% compared to a 10-year Treasury yield of 3.39%, resulting in an above-average-yield ratio of roughly 93%. In the 20- and 30-year parts of the curve, concerns about credit risk and rising rates have driven yield ratios well above 100%, meaning munis yield more even without their tax advantage.

We think today's above-average-yield ratios give munis some cushion against rising rates. For example, if we assume muni yields remain steady, 10-year Treasury rates could increase roughly 50 bps before the historical muni/Treasury yield ratio was restored. That said, going forward we believe the average yield ratio might be slightly higher than the historical average of 80% for the simple reason that, for the most part, muni bonds are no longer insured. And, although yield ratios are currently above average, given the concerns about muni finances and default risk, we wouldn't be surprised to see yield ratios increase from current levels. Toward the end of last year we saw yield ratios well above 100%, so there is downside risk from where we are today.

Specific to the question about higher interest rates, muni performance will depend on why and how fast rates are rising. For example, if the economy continues to slowly improve and rates increase modestly, this could mean a pickup in state revenues and, therefore, an improvement in muni fundamentals that allows yield ratios to fall along with perceived credit risk. But, too quick a rise in rates would outweigh any improvement in fundamentals and drive muni prices lower. Another consideration is that when interest rates move they do not always do so uniformly across the yield curve. Given that the muni yield curve is currently steep, with short-term rates very low compared to long-term rates, it's very possible that rates for shorter maturities will rise more than rates for longer maturities. This, too, will impact our performance expectations in a rising rate scenario. Our positioning along the muni curve currently is in the intermediate portion of the curve, where we believe we're getting the best reward relative to risk.

Looking out over our five-year investment horizon, even in light of the rise in interest rates we're expecting over our five-year investment horizon, if municipal yields normalize relative to taxable yields investors may be able to capture returns that are nearly as high as the current yields. This should equate to pretax returns of around 4-5%, which is better than the returns we expect from taxable investment-grade bonds. We continue to think this makes municipal bond attractive relative to taxable bonds, even though the short-term risks are higher given the fears that exist in the muni market.

—CB&T Investment Team (5/11)

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