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MARKET Commentary

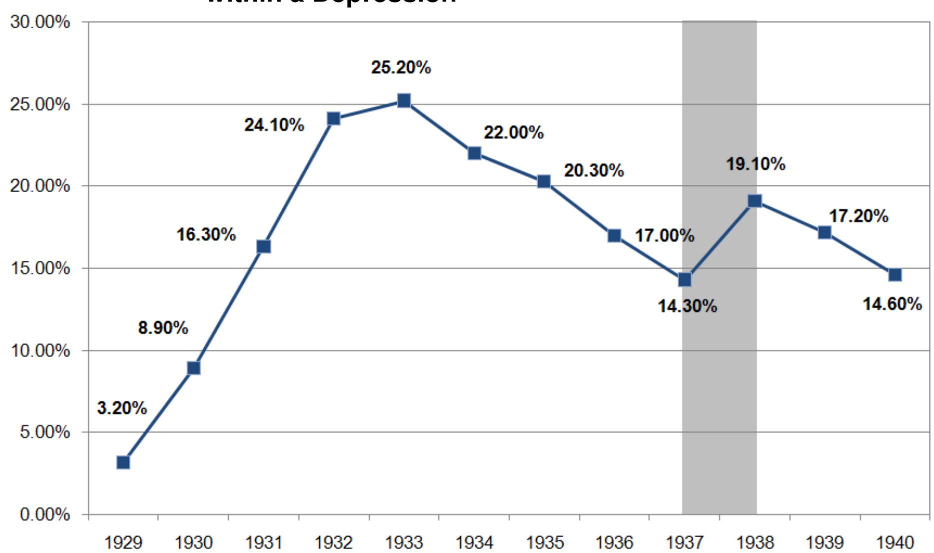
The Great Uncertainty

The weak August employment and housing data support our long-held thesis that the economic recovery is faltering. As policy makers debate another round of action to support the fragile recovery, investors are rapidly losing confidence that additional stimulus will prove effective. The largest hurdle to a sustained economic recovery appears to be the pervasive uncertainty that has entrenched market participants. Removing this uncertainty will require that government leaders reduce their footprint in the private sector and provide clarity, stability and predictability on key economic policies such as financial regulation, fiscal responsibility and taxation.

Learning from History

A good example of how errant policy action can propagate market uncertainty and stifle a recovery is outlined in the New York Times Bestseller *The Forgotten Man* by Amity Shlaes, an interesting look at how government intervention shaped the course of the economy during the Great Depression. Fair warning must be given, however, that reading Shlaes' book in the current environment is like reading about the potential hazards of skydiving while plunging to earth from 10,000 feet.

Figure 1: Unemployment from 1929-1940 Shows a Depression within a Depression



Source: Bureau of Economic Analysis

Shlaes highlights how during various stages of the Great Depression, monetary, fiscal and regulatory authorities too often pursued policies which increased the uncertainty for businesses and private investors. Prominent actions included declaring war on the courts, nullifying contract law, increasing taxes and tariffs and regulating industry production, prices and wages. Shlaes contends that "businesses decided to wait Roosevelt out, hold on to their cash, and invest in future years."

September 2010

US Treasuries

As of 31-Aug

Benchmark	Yield
3 Month	0.14%
6 Month	0.19%
1 Year	0.23%
2 Year	0.47%
5 Year	1.33%
10 Year	2.47%
30 Year	3.52%

Merrill Lynch Indexes

31-Jul to 31-Aug

Index	Return
1-3 Yr Gov/Corp ≥ A	0.25%
1-3 Yr Municipals	0.20%
1-3 Yr Agencies	0.15%
0-3 Month UST	0.01%
S&P 500	-4.51%

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Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan

Government not only had its hand in virtually every aspect of the economy but also ruled with a very heavy hand. In government-targeted industries such as utilities, the damage to the private sector was considerable—resulting in several key players going under. The uncertainty born from extensive government intervention in the economy arguably exacerbated the severity of the downturn, turning a normal recession into a 10-year long depression.

We cannot help but draw comparisons to the current environment and wonder if many of the government actions are doing more harm to the recovery than good. When evaluating the efficacy of policy actions by fiscal, monetary and regulatory authorities, our measure of success is whether policy actions encourage private investment, the backbone of sustainable growth, or discourage private investment by increasing uncertainty. Too often policy actions seem to have resulted in the latter.

"Wait and See"

Economic growth is best nurtured under conditions in which private capital is able to assess properly the long-term risk and return of potential investments. Increased market intervention and unpredictability on the part of policy makers complicates this task for businesses and investors. Economic activity is curbed when providers of capital fall into a dangerous "wait and see" mode—opting to see how existing as well as proposed policies take shape before making critical business decisions.

The expiring Bush tax cuts are a timely example of how the indecisiveness of policy makers has increased market uncertainty and reduced, or at least postponed economic activity. With no clear direction from lawmakers, the market has been left to speculate whether none, all or part of the tax cuts will be extended before the sunset provision at the end of this year. Setting aside any view on whether the tax cuts should be extended, planning for capital expenditures, hiring or general expansion becomes extremely challenging for businesses when cost structures cannot be adequately defined and crucial policies like taxation are not viewed as competitive or stable.

Pay Now or Charge It?

In our view, the greatest sources of uncertainty going forward are excessive government spending, unsustainable levels of debt and the unpredictable regulatory environment. With tax receipts experiencing steep declines, governments have been forced to turn to the public markets in phenomenal size and frequency to fund massive spending packages.

Fiscal stimulus is essentially a redistribution of resources away from the efficient private sector and into the less efficient public sector. Current spending trends indicate that the redistribution of investment activity has been substantial.

When government spends a dollar, the dollar is financed through one of two ways: taxes or debt. In either case, the dollar spent by the government is one less dollar that can be used by private investors. The belief that the government can spend that dollar to increase economic activity better than the private markets is inherently false.

The seemingly widely held view among lawmakers that we can have our cake and eat it too—that we can benefit from high deficit spending without paying the price down the road in the form of higher taxation, lower growth or rampant inflation—is also inherently false. Excessive government spending only delays the pain that must occur for the economy to right itself. As the debt overhang increases, so does the foundation for the next crisis.

Figure 2: Debt-to-Revenue Ratio of Select Sovereign Nations

	Debt/GDP (%)	Revenue/GDP (%)	Debt/Revenue (%)
France	77.6	48	161.67
Germany	73.2	44.3	165.24
Greece	115.1	36.9	311.92
Ireland	64	34.1	187.68
Itlay	115.8	46.6	248.50
Portugal	76.8	41.6	184.62
Spain	53.2	34.7	153.31
United Kingdom	68.1	40.2	169.40
US (Federal Government)	53	14.8	358.11

Source: Eurostat, CBO, Morgan Stanley Research

Morgan Stanley recently released a compelling report on the matter entitled, "Ask Not Whether Governments Will Default, But How," that highlighted the risk of increased debt burdens on future sovereign solvency. The report was not exclusive to European sovereigns either, pointing out that the United States is in just as precarious a fiscal situation as many other European sovereigns deemed to be on the verge of insolvency. Based on some key metrics such as Debt to Revenue (a gauge that many argue is a better indicator of solvency than the traditional Debt-to-GDP ratio), the United States looks to be in worse fiscal position than both Ireland and Greece.

The Great American Subsidy

The Federal Reserve is doing everything in its power to ensure that the fiscal problems in the United States do not derail the already vulnerable recovery. The Federal Reserve has taken unprecedented steps to keep interest rates low, effectively subsidizing the bad fiscal decisions of lawmakers who are spending and borrowing far too much.

Chairman Ben Bernanke in a recent speech given at the Federal Reserve's annual Jackson Hole conference outlined additional policy steps that the FOMC can undertake to ensure that rates remain low to accommodate growth. Chairman Bernanke knows that the Federal Reserve will be forced to subsidize growth until signs of inflation begin to appear or a marked improvement in the job market occurs. As a result of this monetary subsidy, we retain our outlook that the Federal Reserve will remain on hold until at least the second half of 2011 and interest rates will remain range bound for the foreseeable future.

But this subsidy cannot last forever and can only continue as long as buyers of Treasuries, largely the Chinese and other Central Banks, continue to finance the U.S. economy—of which the government is becoming an ever greater percentage. Chairman Bernanke deliberately pointed out in his speech that, "Central Bankers alone cannot solve the world's economic problems" and that current monetary stimulus can only prove effective if lawmakers provide a credible plan to reduce the deficit over time.

Looking Forward

Chairman Bernanke has effectively put all of his cards face up on the table; the question is whether fiscal authorities are willing to do the same by outlining steps for greater fiscal responsibility. The market is anticipating the findings from the newly formed National Commission on Fiscal Responsibility and Reform due out December 1st which will hopefully provide insight into viable ways lawmakers can proceed to control the ballooning deficit. Unless greater clarity from policy makers can be provided to allow businesses to better gauge cost structures and deploy capital for investment and hiring, we anticipate that the current period of low growth will continue well into the future.

Because we expect low rates to persist in the short end of the yield curve, we advise investors to consider extending further out the money market curve into the 1-3 year space. The two-year note is now a money market instrument. Traditional short-duration investors are incrementally extending duration to increase portfolio yield and also benefit from the current shape of the yield curve. Curve roll down provides opportunities to increase the total return of a portfolio, while also providing a buffer against rising interest rates. This is a strategy we see more of our clients implementing as the reality of low rates for the foreseeable future sets in.

Please feel free to contact the desk with any questions.

Form ADV Part II

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