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MARKET Commentary

When More Means Less

July 2010

In the current political environment, we are concerned with the impact that increased political risk could have on client portfolios, the broad markets and the strength of the economic recovery going forward. We have seen many examples in recent months of corporations and investors being held captive by government demands, forced to make concessions that cater more to special interest groups and less to parties with capital at risk—i.e., equity and bond holders. This is a cause for concern, and investors should be wary of industries and companies in which the government and regulators become more active players and less objective referees.

Figure 1: Recent Government Actions Have Favored Special Interest Groups Over Lenders and Investors of Capital

Industry	Public Sentiment	Government Action	Effect on Bondholders
Financial Institutions	*Public anger over the taxpayer funding of the $700 billion bank bailouts.*	*Established seniority of claims in the case of a liquidation of a systemically important financial institution to curtail taxpayer losses.*	*Bondholders are junior to government claims and even secured bondholders may be required to make concessions in case of a company's liquidation.*
Oil Industry	*Residents and environmentalists outraged over the millions of gallons of oil spilled into the Gulf.*	*Forced BP to establish a $20BN escrow fund managed by a third party to pay cleanup costs and legitimate claims.*	*Less cash and resources available to pay off bondholders, including recovery value in case of a bankruptcy.*
Auto Industry	*Current and retired union workers upset over the potential effect of an industry bankruptcy on pension benefits.*	*Forced bondholders to accommodate union pension and medical demands.*	*In the case of Chrysler, secured bondholders were initially offered 30 cents on the dollar. Ultimately, bondholders reluctantly took an equity position in the company.*

Given the nature of political risk, policy makers are more inclined to cater to current constituents without fully considering the lasting impacts on future generations (one need look no further than Social Security as a prime example). This behavior is amplified in election years and even more so in election years projected to be tightly contested. This too often motivates policy makers to act when it is in fact inaction that would prove optimal in the long run.

Even in times of crisis when drastic action is necessary to calm volatile markets, the signaling effect of government intervention is typically interpreted by markets as a tradeoff between reducing short-term risks and increasing long-term uncertainty. After the historic $700 billion bank-bailout package was passed, the S&P 500 plummeted 36.28% before reaching its lows. European stocks, as measured by the DJ Euro STOXX 50, after an initial brief rally are down 7.40% since the European Union authorized its own €750 billion sovereign bailout package in May.

The Arabian proverb holds true that "once a camel gets his nose in the tent, his body will soon follow." The government and regulators are now looking to correct the perceived wrongs of the past, with banks facing increased regulation, litigation, taxes and fees. In the case of BP, in which public anger has reached a breaking point, the demands of the government continue to swell exponentially, and the concessions—including the $20 billion escrow fund managed by a third party—mean at minimum, $20 billion less of resources available to bondholders.

US Treasuries

As of 30-Jun

Benchmark	Yield
3 Month	0.17%
6 Month	0.22%
2 Yr	0.61%
5 Yr	1.78%
10 Yr	2.94%
30 Yr	3.89%

Merrill Lynch Indexes

31-May to 30-Jun

Index	Return
1-3 Yr Gov/Corp ≥ A	0.46%
1-3 Yr Municipals	0.24%
1-3 Yr Agencies	0.50%
0-3 Month UST	0.01%
S&P 500	-5.23%

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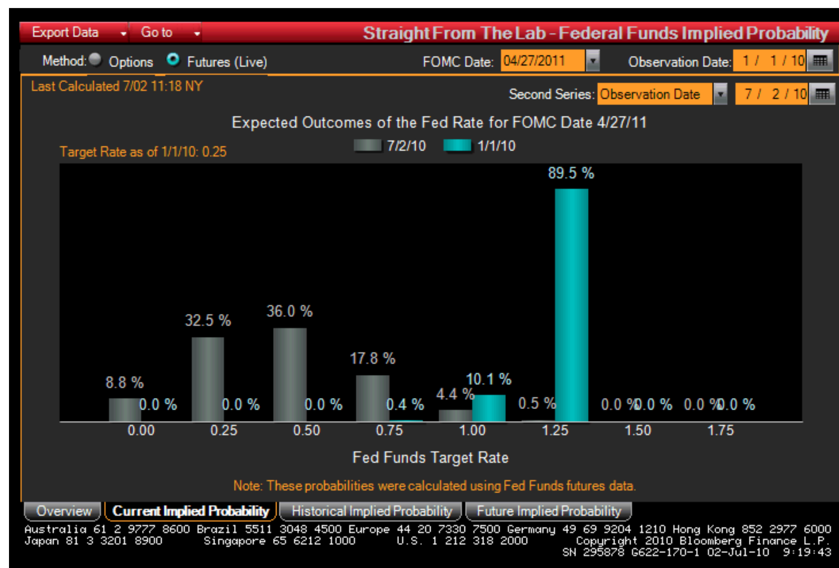
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan

We see no sign of the current administration reducing market interventions, and investors would be wise to pay particular attention to the political rhetoric on a number of important issues in the coming months. We foresee attempts at significant reform in Cap and Trade, restructuring of the GSEs, and tax laws to close an ever-growing deficit, all of which could derail a recovery looking increasingly fragile by the day. As this era of increased intervention continues to unfold, we can only hope that we are not left with less than the less we currently have.

Rates Push Lower

For almost a year we have encouraged investors to consider extending duration into high-grade credits—i.e., treasuries, agencies, and FDIC-backed TLGP paper. This trade would have paid off handsomely as rates have continued to push lower. We believe that this low rate environment will persist well into 2011, and do not expect the FOMC to move on interest rates until late 1H 2011 at the earliest.

Figure 2: Expectations for Fed Funds at the 4.27.11 FOMC Meeting Has Continued to Fall from the Beginning of the Year



The risk between growth and inflation is clearly to growth as the economic recovery faces several headwinds. Unemployment remains elevated with the most recent unemployment report at 9.5%, a drop from the previous reading of 9.7%. The 0.2% drop can largely be attributed to 650,000 people leaving the work force; hardly a positive sign. With the expiration of the new home-buyers tax credit, New, Existing and Pending Home Sales have returned to depressed levels.

In the near term it is deflation, not inflation that concerns us as growth remains tepid. The low supply and demand for credit remain troubling to us. Inflationary gauges show prices contracting, a trend we do not expect to reverse significantly in the near term. Without a strong housing recovery—housing makes up roughly 40 percent of the CPI index—we do not see inflation as a near-term threat.

Looking Forward

New risk in Europe and growing concern in Asia have people questioning whether a double-dip recession in the United States is a real possibility—a thought that many analysts deemed absurd just a couple of months ago when growth and earnings estimates were actively being raised across the board by the Wall Street. We have seen in recent days the Street once again act in a collective unison, this time, however, to temper overly optimistic estimates to growth, unemployment, and interest rate forecasts. We remain convinced that the economic recovery faces real risk, and that the road to a sustained recovery will prove challenging and prolonged.

In addition to the normal economic readings we follow, we will be paying very close attention to the rhetoric and actions of policy makers. As lenders and investors of capital, market participants will need to be on board for any new actions to prove effective. We caution investors to be positioned defensively in this environment in which political risk could have the largest impact on the direction the economy and the markets take in the near term.

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