



Week In Review

January 27, 2012

The Fed Speaks

The Federal Reserve Bank's Federal Open Market Committee (FOMC) met this week. Of note, the FOMC extended the timeframe that it will maintain an exceptionally low federal funds rate "at least through late 2014"...an extension of 12-18 months. As expected, the committee published the individual FOMC participants' expectations for the timing and pace of fed funds target rate moves through 2014 and beyond.

Our Take: Putting the first rate hike date forecast even further into the future is yet another step in the Fed's recent pattern of accommodation. We continue to believe the Fed is on the wrong course as excess debt caused our economic problems and keeping rates low to encourage more borrowing will continue to prove its limited value. A majority of FOMC members expect the first rate hike to take place in 2014, while 6 of 17 believe that the exceptionally low rates are appropriate into 2015 or 2016. According to the data, the median expectation for the fed funds rate is 75bps by the end of 2014. Chairman Bernanke emphasized that this is not a commitment to these rates and are conditioned on the recovery progressing as expected. Obviously, it is extremely difficult to predict the economy in the near term let alone into 2014 and beyond. Economic fundamentals will win in the end.

U.S. Economy

The Bureau of Economic Analysis reported this week that U.S. GDP grew at an annualized rate of 2.8% during the fourth quarter of 2011. GDP grew at a 1.7% rate for all of 2011.

Our Take: Two and one half years have passed since the end of the "Great Recession" and the economy still can do no more than sputter along. Fourth quarter GDP growth outpaced the year but the majority of strength was due to a build-up in inventories. Final demand numbers for the quarter were weak. This quarter's GDP report portends slow growth in 2012.

Europe

The situation is very similar to one week ago. Greece and their private sector creditors remain deadlocked over the amount of "voluntary" haircut the creditors will take. Christine Lagarde, managing director of the IMF, suggested that public creditors (including the ECB) may have to participate in restructuring in order to meet Greek debt to GDP reduction goals. Draghi rejected this idea, and Merkel backed him up. Yields on Italian and Spanish government bonds continued their decline, and Italy just had an auction for shorter-term notes that priced at a yield below last week's auction. Monti continued his push for economic reforms in Italy by taking steps to drastically reduce regulation of business and bureaucracy, and he is opening up negotiations with the major unions to reform the Italian labor market.

Our Take: Time is running out for a Greek restructuring that does not trigger CDS. A restructuring that triggers these derivatives would have a greater likelihood of sparking a financial crisis and of sending Italian yields back up again. The ECB's repurchase operations seem to have been effective in reducing funding pressure on Spain and Italy, but the real test will be next week when Italy issues debt that matures beyond the expiration of the repos. Regardless of whether or not peripheral yields can be kept in check, the question remains open whether these nations can ade-

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quately reduce their debt to GDP ratios without debt restructuring or default. Monti's efforts should help Italy's growth, which will help offset the impact reducing debt has on Italian living standards. This will make default a less tempting option for Italy.

Banking Malaise Continues

By now, most of the key public banks in the U.S. have reported their fourth quarter and year-end earnings. JP Morgan started the pattern of lackluster results, including depressed investment banking and temporarily high legal expenses. Their sentiment rang true for the remaining money center banks. Regional banks fared better, but credit trends are not showing the exponential improvement like early 2011 and interest rate spreads are down substantially. The larger U.S. banks, in general, are desperate for real earnings growth that has not materialized in a slow GDP growth environment.

Our Take: 2012 is shaping up to be another year of disappointment in banking due to frustratingly low spreads between loans and deposit costs, sluggish loan growth, higher capital requirements, and stubborn legal issues. Despite the successful efforts of the Federal Reserve in maintaining record low rates to stimulate spending, many consumers and companies are simply not interested in employing the debt leverage they once did. Banks are ready and willing to lend even with low spreads, but the prospective borrowers lack the forward confidence to use much debt at this time.

Municipals

Many East Rutherford, New Jersey residents are hoping for a Giants win in the Super Bowl on February 5th. The city of East Rutherford is hoping that the Giants organization will pay their outstanding tax bill of almost \$1.5 million, including \$745,000 from 2010, on the team's practice facility, the Timex Performance Center. Last week, Moody's downgraded \$16 million of East Rutherford general obligation debt from A1 to A2. Moody's indicated that their negative outlook was impacted by the litigation surrounding the property taxes of the Timex Center. The Timex Center is East Rutherford's second largest taxpayer. The Giants organization claims that their agreement with the NJ Sports and Expo Authority from the 1970's should still apply to their new facility. East Rutherford claims that the agreement does not apply to the new facility, as it is new construction on a different site built with private money.

Our Take: The fight between the Giants organization and East Rutherford shows how important it is for municipal investors to understand the source of revenues which support the bonds they buy. While both sides should have known what the tax implications of the new facility were before breaking ground, now the decision on the Giants tax liability rests with the courts. It is never a good thing for an investor to rely on a court decision to increase the likelihood of being repaid.

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