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2011  
4th QUARTER



**Craig Cairns,**  
President

### The Equity Market

## Happy New Year!

By Craig Cairns

In looking back over the past year, the theme has quite clearly been volatility. In fact, according to a survey by the SEI Advisor Network, “2011 has been a volatile, nerve-racking, sleep-deprived year.” While this rings true, the volatile nature of this year still seemed very different from that of 2008, where a full blown financial crisis haunted investors daily. This year, acute events have caused fear in investors—such as the US Treasury credit downgrade in August or the more recent debt crisis in the euro zone.

Still, the year was an anomaly in a couple of ways—perhaps most notably was that for the first time in over 70 years, the third year of a presidential election cycle did not lead to an overall market rally. In addition, looking back at economists’ forecasts for 2011, most overshot the year, putting the S&P 500, 10-year Treasury note yield, and GDP growth all higher than what they turned out to be. Interestingly, despite the extreme intraday volatility, the year was flat overall.

While the first half of the year was marked by slow economic growth, we saw a bounce in the third quarter, and the momentum from that has carried through the end of the year. There was a clear rise in the economy at December’s close. We saw several analysts’ forecasts beaten or surpassed by actual numbers. Some economists declared that the economy was growing 3 to 4 times as quickly as it was early in the year. While it is always comforting to read healthy economic statistics, especially in hopes of a long awaited recovery, it is likely that the path to sustainable recovery is a long and complex one that won’t be reached merely through some positive economic data. There remain on the scene several systemic issues that we expect to be dealing with throughout the foreseeable future. Let’s take a look at how the last quarter of 2011 unfolded.

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**Vince Russo,**  
Vice President, Director  
of Fixed Income Research

### The Bond Market

## 4th Quarter Overview

By Vince Russo

This past quarter sent mixed signals regarding investors’ appetite for risk. It was characterized by continued volatility in the bond markets, but the month of December seemed to close with stronger demand. With the exception of foreign sovereigns and foreign agencies, the remaining sectors of the taxable bond market produced positive returns for the period (as of this writing – 12/28/2011). In general, even high-yield bonds posted strong positive returns as they rebounded from a clearly negative 3rd quarter. The municipal bond market was also among the strongest performing sectors during the quarter and for the entire year of 2011.

### Municipal Bond Defaults – The Warning that Fell on “Deaf Ears”?

Meredith Whitney received a great deal of attention in the financial markets due to her analysis of the issues facing Citigroup in October 2007. Whether it deserved the notoriety it received is debatable. However, she did focus on the weaknesses of the bank’s balance sheet and did correctly raise concerns that financial institutions could potentially be at risk if they did not take proactive steps to improve their balance sheets by selling assets, reducing debt, and increasing capital.

It is not surprising that Ms. Whitney’s warning about a spate of municipal bond defaults on the December 19, 2010, broadcast of *60 Minutes* created such a stir. In spite of this dire prediction’s temporary negative effect on the bond markets earlier in the year, municipal bonds have been viewed by the markets as a value proposition relative to Treasury securities.

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## October at a Glance

October was an impressive month for the markets, especially after a couple of significantly dreadful days toward the end of September. The S&P 500 rebounded by almost 11%, after being down 7% for September. However, October didn't defy the trend of volatility that we've had to grow so accustomed to the past few months. That volatility has stemmed largely from the European Union. Daily, the European Financial Stability Fund, European Central Bank, and euro zone leaders seemed to be holding yet another meeting and overcoming yet another hurdle on the path to averting both Greek and Italian defaults.

Greece had an eventful couple of weeks toward the end of October. After initially reaching a tenable rescue package for the country, severe unhappiness among the Greek populace caused Prime Minister Papandreu to consider holding a referendum on the bailout plan. However, in the face of pressures from other European powers, Papandreu was forced to drop the issue and look to other means for getting the bailout plan passed. Papandreu formed a coalition with the opposing New Democracy party's Antonis Samaras. Papandreu agreed to step down as Prime Minister, while Samaras agreed to support the debt deal in return. The country then came to eventual consensus on Lucas Papademos leading the temporary unity government in pushing the bailout plan through Parliament.

## A Snapshot of November

November felt like a drawn out round of the waiting game. Americans waited on news of a long-term spending agreement from Congress' Joint Select Committee on Deficit Reduction, as well as any updates on the euro zone, and simultaneously rode out some pretty awful days in the markets.

On Monday, November 21, just days before the super committee's deadline, the co-chairs of the committee announced that it was unable to present a bipartisan agreement to the public by its deadline. What Americans had feared, but hoped they had been wrong about, came to fruition before Thanksgiving. Unless action is taken to change the current law put in place this summer, which President Obama has stated he will not allow, automatic spending cuts will go into effect beginning in 2013, which involve cuts to both domestic and defense programs.

To wrap up the month of November, there was a downgrade warning issued to over 80 European banks—but investors didn't seem to mind too much. The markets saw one of the biggest rallies it had experienced in years, with the S&P 500, Dow Jones, and Nasdaq indices rising 4% or more. Such a rally has only been seen a handful of times since the financial crisis three years ago. Financial entities, in particular, were bolstered by the upward movement in the markets. Perhaps the rally was due in large part to the concerted initiative of many of the world's leading central banks to lower the cost of emergency funding to European banks. The US Federal Reserve, Bank of Canada, Bank of England, Bank of Japan, Swiss National Bank, and European Central Bank joined together in agreement to lower the interest rate on US dollar liquidity swaps. Essentially, in recognition of the rising expense of European banks borrowing money in dollars, this agreement

would encourage banks to borrow by making it cheaper by 50 basis points, or .5%.

## Wrapping Up the Quarter

In the second half of December, the number of Americans filing new claims for jobless benefits hit a 3 ½ year low. Other US data has been equally positive, such as higher consumer confidence (partly due to a sizable 70 cent decline in gasoline prices), healthy household spending, and improved home building. The four week moving average, considered a strong measure of labor market trends, dropped to its lowest level since June 2008. According to ISI (International Strategy & Investment) on December 29, unemployment claims were below 400,000 for the 4th week in a row, and for 7 of the previous 8 weeks. Economic releases indicate that real GDP will advance 4.0% or more in the fourth quarter, and payroll employment will also increase. This is all evidence of positive growth, albeit not enough to feel like a true recovery. Housing continues to be the missing piece to the domestic economic puzzle, with data still incredibly weak.

With regard to the European Union, The President of the European Central Bank announced that the Central Bank would offer to lend money to banks for three year terms, in unlimited amounts, at the very low interest rate of 1%. Then, on December 21, the ECB announced that 523 banks would borrow a total of 489.2 billion euros, surpassing most forecasts.

This has acted as a catalyst for restoring hope in many people's minds about the future of the region. Many economists believe that this aggressive move by the ECB could finally be a defining moment in the euro zone's debt crisis. It certainly shows some healthy and refreshing initiative to straighten out the region's fiscal balance sheet. This action, overall, economists predict, could put 190 billion to 270 billion euros of new money into the European financial system.

## Where Do We Stand?

The real issue going forward is how the global economy, and the euro zone in particular, will affect our domestic economy which seems to have found its footing and stabilized many of its fundamentals. Some of our growth and recovery will undoubtedly be counteracted by deep recession in Europe, although we are not of the belief that the US will hit a wall of its own as a result. It would be naïve to think that with the ending of 2011 comes the end of 2011's struggles. This euro zone debt crisis has most likely not yet come to a head, and therefore we will be prepared to deal with its ramifications for the US.

We wish we had answers to the most pressing questions surrounding the situation in Europe. However, inherent in the situation's risks is the degree to which no one truly knows the implications. As your investment manager, the best we can do is stay on top of our investments and hedge against risk wherever we see necessary.

Volatility remains the name of the game. Fear of the unknown, especially regarding the EU debacle, has taken center stage and precedence over the

economic statistics and forecasts that historically drive the markets. At the rate we are going, jockeying between risk-on and risk-off trading is not going to be a thing of the past anytime soon. It seems until the looming nature of debt problems across the pond truly cease, investors will continue to act based on daily updates to the geopolitical scene—hence the ups and downs we have seen throughout the quarter, although we believe the trend will be generally upward.

It remains true that although the threat of recession in Europe looms above us, the US has continued to hold its own throughout the year, with slow growth, just as we have been predicting. Although it certainly hasn't been a year of a bullish stock market and a booming economy, we cannot complain that in the face of several bleak indicators, the US has managed to hold off recession and grind out some measured growth.

## Our Game Plan

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As always, we continue to “stress test” our portfolios for downside risk under various possible scenarios. In conducting such analysis, if we identify certain positions that may have significant downside risk, we will act accordingly, by either reducing or eliminating those positions.

Clearly, there are two equally important pieces to the puzzle, and we plan to be both strategic and disciplined in our approach to both sides of the equation: protecting and monitoring our current investments, and looking to seize opportunities in a time where risk and volatility can make good stocks cheap. We have seen the benefits of “riding out the storm,” especially when the storm is one largely driven by emotional fear. The biggest mistake investors can make is to think that the current slow growth environment is not suitable for making money—it just may require more patience and commitment.

## *The Bond Market* continued from page 1

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As I have already noted, municipal bonds have turned in a very strong year of performance in 2011 in spite of two major bankruptcy filings (not the 50 to 100 or more sizeable defaults Ms. Whitney is on record for predicting) in the sector (Jefferson County, Alabama, and Harrisburg, Pennsylvania). Both of these defaults have occurred within the last couple of months and both are being contested in the courts. There is some doubt regarding whether or not these municipalities could legally be afforded bankruptcy protection. In the case of Harrisburg, a bankruptcy judge ruled that the city could not file for bankruptcy in order to get out of paying its debt. Pennsylvania law requires state approval before a municipality may file for bankruptcy protection under Chapter 9 of the US Bankruptcy law.

The way her ominous prediction was reported and discussed in the media shortly after it was made would lead us to think that this person is a “scaremonger.” However, when I reviewed the transcript of the broadcast, her opinion, in general, makes a great deal of sense.

*Whitney believes the states will find a way to honor their debts, but she's afraid some local governments which depend on their state for a third of*

*their revenues will get squeezed as the states are forced to tighten their belts. She's convinced that some cities and counties will be unable to meet their obligations to municipal bond holders who financed their debt. Earlier this year, the state of Pennsylvania had to rescue the city of Harrisburg, its capital, from defaulting on hundreds of millions of dollars in debt for an incinerator project.*<sup>1</sup>

I do not believe the opinion is irrational. It is an accurate statement that states are cutting back on the amount of revenues they provide to local municipalities and school districts. In essence the budgetary problems at all levels of government are being pushed down the “pipeline” of public finance. The federal government is cutting back on the funds it passes along to the states, and the states are cutting back on the funds they pass down to the local levels and state agencies. This has led to an outcry from mayors, county executives, school boards, and school administrators that reducing state aid without a reduction in state and federal mandated expenditures will undoubtedly lead to a cutback of services and public programs along with increased taxes. Many local governments and school districts have very little left in the way of discretionary spending that can be reduced.

Therefore, the warning about public finances may not have led to the defaults anticipated by Ms. Whitney in 2011, and may not ever materialize if municipal government administrators can continue to reduce costs elsewhere. However, that raises other questions regarding the quality of public services that taxpayers are currently funding. No one wants to pay for something and get less of it. Local governments and school districts will eventually have to explore more ways to deliver services more efficiently; otherwise all municipal government obligations may be negatively affected. That being said, I do believe that other creditors will be more negatively affected than bondholders. As was the case in Pennsylvania, no state that relies heavily on the public finance market for bonds wants to create a situation that would make it difficult for them to refinance their own debt.

## The European Problem— No Easy Solution in Sight

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The uncertainty over the fiscal imbalances of some members of the European Union not only continues to make headlines, but is the single most important contributor to the volatility in the global markets. Yes, there are other economic and political variables that are having a marginal impact on the global capital markets, but the European story continues to be most influential, because it has the potential of being the most unsettling to the global banking system.

Greece is still a problem, but most of the focus this past quarter has shifted to Italy, with Spain most likely the next target of the capital markets. It is not surprising that the focus would have shifted given that Greece's public debt is approximately € 408 billion as of 3-31-2011 (or at an exchange rate of 1.3 \$/€ - almost \$530 billion), while that of Italy is € 1,847 billion as of 9-30-2011 (or almost \$2.4 trillion).

<sup>1</sup> www.cbsnews.com, State Budgets: The Day of Reckoning — December 19, 2010, CBS News: Producer: Scott Jacoby.

If we include Spain in the conversation, that would be € 1,772 as of 9-30-2011 (or almost \$2.3 trillion).<sup>2</sup>

Each of these countries has gone through a change of government during the past quarter, directly related to the problems surrounding their fiscal imbalances. In the case of Greece and Italy, the governments are “provisional” and not currently elected—an emergency measure to deal with the lack of confidence in the previous governments’ ability to lead during this turbulent economic time. It has been widely publicized that each new government’s approach is to try to implement radical structural changes in spending on pensions and other public services and try to eliminate obstacles to competition in the private sector. But, the predominant theme is austerity.

While austerity measures will certainly begin the stabilizing process desperately needed to improve confidence in the global capital markets, the key to any of these economies is real growth. All countries compete for a bigger piece of the economic pie in order to improve standards of living for their citizens and for their continued prosperity. However, this will not be easily accomplished during this cycle and therefore, austerity may be the only real solution at the present time.

I am not aware of other preferable solutions, or at least any that would realistically be implemented voluntarily. One of the important advantages of a common currency like the euro is the notion that it facilitates capital flow from member state to member state without barriers. So, if good capital investment opportunities existed in Greece, a German investor would be able to move capital to Greece without barriers. The investor would be able to efficiently allocate capital, and the business entity in Greece would be able to find capital more efficiently. This dynamic may be changing because of the lack of confidence in some of the Southern European members. Greece and Italy are trying to stem the potential for capital flight and unfortunately, any policy implemented to reduce this risk will also have the unintended consequence of limiting new capital investment from foreign accounts.

A solution that has been talked about recently is the “break-up” of the European monetary union, promoting the exit of the weaker economies or the exit of Germany. Either option is not very realistic nor without severe consequences that would extend beyond the European continent. Either option would have an immediate impact on the weaker, struggling economies. Even the strongest economy in Europe, Germany (and particularly its banks), would feel the negative effects of its neighbors’ deep recession in the aftermath of a euro exit. Aside from the technical uncertainties of how any of these countries would “de-peg” from the euro, the market would have a difficult time establishing a valuation on the new Lira or Drachma or Peseta. All of these had an established exchange rate when each country entered the euro, but those exchange rates would not apply today.

Perhaps a good example of the effects of such a break from a fixed exchange rate system is that of Argentina in 2001. For approximately a decade, Argentina had maintained a fixed currency exchange of 1:1 with the US dollar. The goal was to reduce economic instability due to persistently

high inflation rates and hopefully gain the confidence of international investors to bring capital investment to Argentina. It worked well, until the global recession of the late 1990s and early 2000s made the fixed exchange with the US dollar unsustainable. In the aftermath of the “de-pegging,” Argentina’s economy went through a major crisis that included debt restructuring, runs on banks, limits on withdrawals from banks, looting and rioting, suspension of payments on public debt, and a devaluation of approximately 75% and a sovereign default of over \$100 billion.

Even if we were to adjust the \$100 billion for inflation, it is still far less than the amounts I mentioned earlier for Greece, Italy, and Spain. The banking system in Europe and worldwide would be severely impacted, creating dangerous insolvencies. Surely, this is not a preferred solution and one I hope we never have to put to the test.

## Howe & Rusling 2011 Holiday Donation

In the name of our valued clients and friends this holiday season, Howe & Rusling made a donation to the American Cancer Society and sent a care package to 2nd Platoon, Destroyer Company, 2-87 Infantry of the US Army in Afghanistan.



We wish you a happy, healthy, and prosperous year ahead!

<sup>2</sup> Ned Davis Research — Greek, Italian, and Spanish Total External Public Debt. Data provided by Haver Analytics to Ned Davis Research.