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Pessimism, Uncertainty Plagues U.S. Recovery

The momentum that had been building towards a sustainable US economic recovery has given way to uncertainty and renewed concerns of a possible double-dip recession. Since our last newsletter, elevated European sovereign risk, the oil spill, a desire-to-regulate political climate, and a stock market selloff have dominated the headlines, with little if any positive economic news to offset the negativity. The reality of high unemployment and a feeble housing market has returned to the forefront, generating strong headwinds against the consumer – the ultimate driver of any potential turnaround.

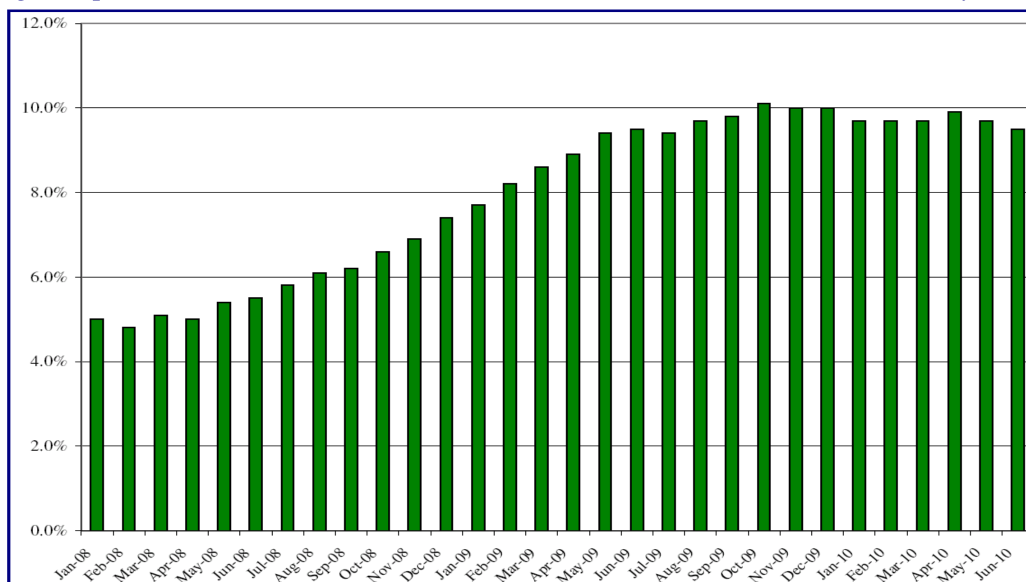

Figure 1. *Unemployment Rate since January 2008* Source: Bloomberg

The unemployment rate released in early July fell slightly to 9.5%, down from its October 2009 high of 10.1%. Minor improvements such as this hardly ease anxiety over the prevailing joblessness around the country. New jobs data and economic forecasters continue to warn of the long, arduous path ahead for the labor market. It is estimated that between 16% and 17% of the labor force is currently underemployed – i.e. working at a level below their training and/ or pay grade. As long as jobless numbers flirt with 25-year highs and the U.S. fails to maximize its workforce, the economy will likely find it difficult to achieve a sustainable rebound.

While the hemorrhaging of the housing market has eased, glimpses of a recovery have been fleeting. The first-time home buyers' tax credit has been recognized as keeping the housing market on life support over the past two years and there are fears demand will pull back as the incentive program expires. Consumer sentiment has taken a recent hit, and with the extensive queue of mortgages in foreclosure limbo, fundamentals offer little optimism for any significant improvement in real estate.

Highlights:

- Fed maintains 0-0.25% Fed Funds rate for Twelth consecutive session
- Caprin continues to monitor local and state budget health as fiscal struggles persist
- Caprin building portfolios with a slight "barbell" structure, emphasizing longer and shorter maturities
- We continue to manage to a neutral target duration of 5.0 years

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In response to these ongoing economic anchors and Europe's evolving fiscal struggles, the Fed found no reason to tighten monetary policy and left the Fed Funds rate in its existing 0% to .25% range. The Fed's statement contained slightly less confidence in the economic recovery over the near-term. Fed Chairman Bernanke gave no indication that the Fed is considering higher interest rates in the foreseeable future, and Fed-watchers speculate whether the risk of deflation will prompt the Fed to consider another round of quantitative easing. While public commentary from Fed officials has been mixed, Bernanke has in the past stressed the importance of aggressively battling deflation. As growth forecasts are being revised downward and the optimism that had surfaced in the first quarter of 2010 wanes, we believe a prolonged recovery may be the most likely scenario.

Caprin Strategy

As financial struggles have continued to mount abroad and the outlook at home has deteriorated, treasury and municipal interest rates have declined reflecting a flight to quality and muted economic expectations. Since our May newsletter, municipal bonds have rallied despite persistent headlines over budget concerns at the state and local level. Furthermore, the past few months have seen a drop in new municipal debt issuance, constraining supply to a steady if not growing pool of demand. As we have discussed in several previous newsletters, Build America Bonds (taxable, federally subsidized municipal bonds) continue to cannibalize new tax-exempt issuance, primarily in the 10-year-and-longer portion of the curve.

The uncertain economic landscape has led Caprin to remain duration-neutral to our benchmark with a slight barbell maturity structure for the time being. We believe the Fed's timetable for a higher interest rate policy has been pushed back into 2011, boding for persistent low rates for short maturity bonds. Where appropriate, we will seek opportunities to sell into an insatiable money market environment overvalued bonds with maturities less than one year and reinvest proceeds into maturities ranging from 1 to 3 years. We will continue to carefully monitor the economic outlook so that portfolios can be postured appropriately in the evolving interest rate environment.

Our investment strategies remain keenly focused on the health of state and local economies as governing bodies adjust to this economic downturn. Elected officials are working diligently to fill the cash flow gaps using various solutions including employee furloughs, pay cuts, tax increases, stimulus money requests, etc. Longer term, if slower growth persists, governing bodies may have to face additional challenges for providing adequate public services and stable infrastructures.

Credit awareness and monitoring remain essential to guiding fixed income portfolios through this rehabilitation period. In many respects, the municipal sector parallels the cash flow and balance sheet repairs underway in many segments of our domestic economy. It is likely that conflicting themes will drive valuation and demand metrics for the foreseeable future. For example, the prospect of higher income taxes may increase demand for tax-exempt securities, and drive yields lower. On the other side, yields may spike as they did in late 2008 if an unforeseen credit concern or event disrupts the market. Ongoing surveillance and proactive management will drive our initiatives as we seek to manage risk and to invest opportunistically for client portfolios.

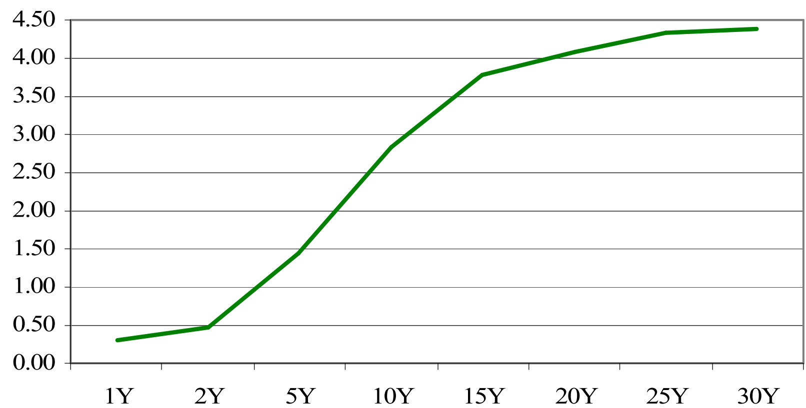

Fig 2. *U.S. Muni G.O. AAA Yields as of 7/20/10* Source: Bloomberg

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