If At First You Don’t Succeed, Try, Try Again

The summer delivered punch after punch of uninspired economic data punctuated by anemic job growth and stalled improvement in the unemployment rate. At its most recent meeting, the Federal Reserve met long simmering market expectations with the announcement of the next round of Quantitative Easing, dubbed “QE3”. Once again the FOMC is flooding the market with liquidity in hopes of stimulating economic activity. Bernanke & Co. will be buying $40 billion per month of Agency Mortgage-Backed Securities.

The trillion dollar question remains: will it work? Since the 2008 financial crisis, we’ve seen unprecedented efforts from directors of fiscal and monetary policy to salvage and kick start the US economy. The tally is staggering:

<table>
<thead>
<tr>
<th>Date</th>
<th>Policy</th>
<th>Estimated $$</th>
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</thead>
<tbody>
<tr>
<td>Fall 2008</td>
<td>Troubled Asset Relief Program (TARP) – Bush Administration</td>
<td>$700B as announced (ultimately $431B)</td>
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<tr>
<td>Fall 2008</td>
<td>Quantitative Easing - FOMC</td>
<td>$1.3T (est)</td>
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<tr>
<td>Spring 2009</td>
<td>American Recovery &amp; Reinvestment Act (Stimulus Bill) – Obama Administration</td>
<td>$831B</td>
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<tr>
<td>Fall 2010</td>
<td>QE2 - FOMC</td>
<td>$600B</td>
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<tr>
<td>Fall 2011</td>
<td>Operation Twist - FOMC</td>
<td>$400B deployed, grew to $667B, ($0 increase)</td>
</tr>
<tr>
<td>Ongoing</td>
<td>Fiscal Deficits – Obama Administration</td>
<td>&gt;$1T/yr</td>
</tr>
<tr>
<td>Fall 2012</td>
<td>QE3 - FOMC</td>
<td>Open ended, $40B/mo</td>
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Trillions of dollars have been injected into the US economy since late 2008 – and counting. What do we have to show for it? Despite a fit here and a start there, the US economy has been unable to gain the necessary traction to sustain recovery. The unemployment rate, while off its highs, is stubbornly stalled at elevated levels, not to mention the underemployment picture, which is markedly worse. And now the Fed is back at the table with more liquidity and further asset purchases.

Let’s look at the efficacy of all of this. We are clearly not seeing anyone’s definition of economic recovery as measured by GDP growth and the employment market. Supporters will tell you that policy prevented the situation from being far worse, but it is hard to call this a success.
All this is indicative of the limitation of monetary policy to stimulative economic activity. In a different take on an old adage, monetary policy brings more water to the horse, but it can't make the horse drink. We have yet to see all this liquidity translate into sustainable growth in economic activity, and because growth has been so anemic, we have yet to see stimulative liquidity unleashed in the market ultimately manifesting into higher inflation. What we have seen is investment inflation.

Pop Quiz - since the onset of stimulus in 2008, would you rather have owned treasuries or stocks?
Answer - it doesn't really matter.

We have been trained to look at the world in mini cycles of risk on or risk off. This has us choosing between safe haven treasuries and higher risk equities. And while these asset classes can diverge in performance over short windows, the long-term trend across all three is upward. This is the result of stimulus, both monetary and fiscal. Trillions of additional dollars in the system. Not showing up in economic recovery, but clearly evident in inflationary investment prices.

So, as long as the prescription remains more liquidity and more stimulus, we would expect continued inflation in investment prices. We continue to navigate between risk on and risk off profiles to make the most of our allocation. But so long as the Fed is investing we expect positive price trends to persist and cash to be the only real losing asset.

Balancing Act: Short-Term Volatility vs. Long-Term Outlook

Over the past few weeks, fixed income markets have experienced a wild ride, beginning with the European Central Bank’s unveiling of its new rescue plan, followed by the U.S. Federal Reserve revealing its third round of quantitative easing. The broader “risk on” trade that ensued has since given way to a growing sense of skepticism over the central banks’ actions and their potential effectiveness. U.S. Treasuries retraced much of their losses formed in the wake of the announcements, as investors sought out traditionally “safer” assets. This short-term volatility illuminates one of the hardest aspects of fixed income asset management: absorbing brief bumps in the road in favor of positioning that is consistent with a longer-term outlook. We believe that the Fed’s pledge to maintain low interest rates into 2015 justifies managing our portfolios to a duration longer than their respective benchmarks to capitalize on a highly accommodative policy environment.

Intermediate Municipal

Municipal trading activity and new supply levels hovered well below their annual averages in the month of August; however, we have seen both come alive in September. Thus far, new supply has been met with strong enthusiasm, especially in the recent trading sessions that saw the demand for quality assets return to the fore. There appears to be plenty of demand pent up from the summer
months where supply was insufficient to meet investors’ needs. Furthermore, much of the supply has been skewed towards lesser-rated, higher-yielding names and sectors (healthcare, power, housing, etc.), which has helped the placement of such debt among the yield-starved fixed income audience. By preserving positions that are consistent with a long-term accommodative Fed and a bias for buying strong issuers offering investors incremental yield, we have been able to navigate a brief move to higher yields, buy bonds at cheaper prices, and benefit from the subsequent rally after the Fed and ECB euphoria started to wane.

**Short Maturity – Municipal and Taxable**

The front of the yield curve remains insulated from the larger fluctuations seen in longer maturities. Expectations for suppressed short-dated rates have helped prevent more violent reactions to Euro and U.S. developments. We continue to overweight higher yielding sectors (i.e. corporate and taxable munis in Caprin taxable strategies; AA and A-rated revenue sectors in Caprin muni strategies) in an effort to augment yields. Also, by managing duration to a mark longer than the benchmark, portfolios can extend a bit further out the yield curve and capture more attractive yields.

**Intermediate Taxable**

By rotating shorter corporate bond maturities concentrated in the first three years out into the five- and six-year maturity range, the intermediate taxable strategies benefited from strong performance in that part of the curve throughout August. Much like the municipal market, the appetite for yield and risk in the taxable market is boosting the sector’s performance. Furthermore, a well-timed roll from shorter U.S. Treasuries to longer maturities in a similar fashion provided additional yield and helped maintain a longer duration bias. This posture has responded well to the rejuvenated flight-to-quality in recent trading where longer maturities have outperformed.

**Managed ETF**

The flexibility provided by our ETF-based strategies has been important in the quickly evolving economic landscape at home and abroad. The philosophy behind our ETF positioning is consistent with our other strategies: a long duration bias and exposure to High Yield and risk sectors. We have raised some cash in each of our three strategies (Muni, Taxable and Blend ETF) to create additional nimbleness until a more stable sentiment takes hold. On August 20, following Germany’s endorsement of the ECB’s bailout program, we added exposure to an International ETF in our Taxable and Blend ETF strategies, believing that Europe had taken a small but crucial step in addressing the region’s debt crisis. The International fund selected has outperformed the strategies benchmark since the purchase, but we believe it is still an exposure requiring close surveillance.

U.S. debt markets feel as though they are in a form of sentiment purgatory right now, undecided on which way to go from here. Do the Fed and ECB’s plans offer a panacea to their respective economies struggles? No, but they do offer a promise of accommodation and support from the most influential central banks in the world. This Fed’s accommodation is the primary driver behind our long duration bias across all strategies. But we also believe the Fed will be ultra-accommodative only as long as it needs to be. We remain comfortable with our current positioning and efforts to boost income in portfolios because of the ongoing demand for haven assets and the major obstacles that still could hinder the global recovery. Between the upcoming U.S. election, fiscal cliff debates, implementation of QE3, the European Stability Mechanism, and the stubborn housing and labor markets, we yet have a long way to go.