

US Market Watch

Markus Schomer, CFA, Chief Economist

December 2011 (As of 13 December)

Review

Is this a case of “dèjà vu”? Reminiscent of the end of last year, US economic news is getting better and investors are returning to risk assets. Is the recovery finally gathering steam again? First of all, we remember what happened at the turn of last year and the disappointment that followed in the first half of 2011, as a result of headwinds we didn’t anticipate. Looking into next year, now more sensitized to look for those headwinds, there are still risks from the ongoing fallout from the Eurozone Debt Crisis and fiscal headwinds related to Congress’s inability to agree on long-term debt reduction. I am not sure which will play the role of the Japan earthquake that disrupted the global recovery early this year, but my US growth forecasts continue to show heightened volatility throughout the next two years before settling into a more conventional recovery path in 2014.

Equity markets have been trending sideways in recent weeks, holding on to much of the strong October gains. In fact, the S&P 500 is again flat for the year and the large cap Dow Jones is up 5% year-to-date at the start of December. There is a similar story for US Treasuries, with 10-year yields falling only slightly in October after a 20 basis point gain in the prior month. High yield and emerging markets credit markets started December with a more positive tone, regaining some of the ground lost during the selloff last month. As one would expect, the trade-weighted Broad US Dollar Index weakened again, consistent with the better performance of risk assets in early December. However, the dollar’s performance is more uneven so far this month, with European currencies continuing to underperform.

Economy

To my surprise, the recent US economic news flow has improved notably, highlighted recently by fairly bullish headlines following the November US jobs report. The Unemployment Rate dropped from 9% to 8.6% in just one month, the lowest rate in 33 months, yet, half of the decline was the result of fewer people looking for work and thus dropping out of the labor force. In addition, the report showed the number of sectors reporting growing employment fell to a 14-month low. Retail Sales have held up well in September and October, despite my concerns over declining Real Disposable Incomes, and stronger service sector business activity in November suggests the robust spending trend may be extending into the important holiday shopping season. Consumer Confidence is improving again, and the net 120,000 increase in nonfarm payrolls probably underestimated the pace of new job creation; I put more stock these days in the ADP Employment Report, which showed a more bullish 206,000 increase in private sector jobs.

Can this improving growth momentum carry into next year? I have to admit I am still skeptical. First, I expect fiscal policy will turn more restrictive next year. State and local governments are in the second year of their fiscal adjustment programs to reduce post-recession budget deficits, and the Obama administration will struggle to get all expiring fiscal stimulus measures extended. Second, I still believe the growing gap between household income and spending will have to narrow again. Maybe income is underreported and will be revised up. However, I could also see a consumer hangover after the holidays. Stronger spending is partially

financed by a reduction in savings and an increase in borrowing; both are trends that should not be sustainable in the current environment. Home sales have rebounded in recent months, but I am not convinced we are at the start of a sustained rebound in US housing. I don’t see much of a wealth effect either. Home values are still falling, money market savings earn nothing, and stock markets are flat at best this year. The bright spot in the economy is still the corporate sector. In the third quarter, corporate profits as a share of GDP, rose within a whisker of the post-war record of 13.2% from the early 1950s. Clearly, corporations have the ability to increase production and employment. Furthermore, it seems companies are reassessing the uncertainty over the US and the global macro outlook and are starting to increase hiring. That is a powerful trend that could very well carry the economy into 2012 and maintain the growth momentum near the upper range of our current 1% to 3% “moderate growth” base case for the US. My forecast is a hybrid of both arguments, looking at just 1.7% growth in the first half of 2012, but followed by a stronger 2.8% trend in the second half.

Policy

The Federal Reserve must have thought this could be a quiet holiday period. “Operation Twist,” the latest program which entails selling US \$400 billion of short-term Treasuries and buying the same amount of longer-term government bonds, is being implemented, the US economy is improving, and calls for more Fed action have gone quiet. However, the Eurozone Debt Crisis is now affecting US monetary policy as well. The Fed

felt the need to extend its dollar swap arrangements with all major European central banks and cut the rate charged for providing dollar liquidity to European banks. Dollar funding markets are drying up as more and more US banks refrain from doing business with their European counterparts; hence the need for the Fed to step in and perform a classic "lender of last resort" function, even outside the US.

The widely anticipated failure of the "Super Committee" has come and gone with little impact on financial markets. On the one hand, it emphasized the inability of Congress to deal with the nation's most pressing problems - a problem that triggered the summer ratings downgrade. On the other hand, it set in motion a process that will now more or less automatically lead to significant deficit reduction, but with much harsher consequences for the economy. It is still possible that Republicans and Democrats will agree on a comprehensive deal next year. However, Republicans turned down the Democrats' offer of three dollars in spending cuts for every one dollar in tax revenue increases, but somehow allowed the process to force on them a 50 cents in spending cuts for every one dollar in new tax revenues deal. This suggests any compromise would be a huge political loss; hence, Republicans will have little desire to agree to any new deal, staking their hopes on winning next year's elections. In that case, significant fiscal tightening will be triggered in 2013, which should prevent a stronger recovery from taking hold until, at best, later that year. Similarly, while some of the fiscal stimulus measures expiring at the start of 2012 may get extended, I assume they will not be extended to their full extent and certainly there will be no additions to them. Hence, we will see moderately

tighter fiscal policy next year that should weigh on the fragile recovery we are experiencing right now.

Interest Rate Strategy

Our interest rate forecasts continue to envision only a gradual increase in Treasury yields. We currently assume no further quantitative easing, rather a gradual wind down of the Fed's current measures. On balance, that should put only moderate upward pressure on 10-year Treasury yields over the course of the next two years. Inflation hasn't played much of a role in determining bonds yields as of late, and the current peak in the inflation cycle and the erratic macro backdrop should prevent any significant upward pressure purely due to economic fundamentals.

Strained liquidity conditions remain the main driver of our fixed income credit strategy. We reduced risk in our portfolios in November and are likely to maintain our more neutral stance into year-end. However, the improving economic conditions and the better stock market performance should bolster high yield and emerging markets in the coming weeks.

Looking ahead into 2012, our firm's fixed income strategy is not likely to change much in the first half of the year. Bond yields should increase modestly in the second half on the back of improvements in the Eurozone Debt Crisis and improving growth expectations in the run-up to the Presidential elections. The future path of interest rates depends greatly on what happens with the 2001/03 tax cuts at the start of 2013. ■



Markus Schomer, CFA
Chief Economist
PineBridge Investments,
New York

Markus Schomer is responsible for providing macro-economic forecasts, analysis and commentary for all PineBridge Investments groups, with a focus on global economic trends and their impact on financial markets. He holds degrees in Economics from the University of Bonn in Germany and the University of East Anglia in the UK. He also studied at the London School of Economics and is a CFA charterholder.

PineBridge Investments is a group of international companies acquired by Pacific Century Group from American International Group, Inc. in March 2010. PineBridge companies provide investment advice and market asset management products and services to clients around the world. PineBridge Investments is a service mark proprietary to PineBridge Investments IP Holding Company Limited. Services and products are provided by one or more affiliates of PineBridge. Certain middle and back office functions incidental to the services and products provided by PineBridge Investments and its affiliates may be outsourced to third parties. Certain information may be based on information received from sources PineBridge Investments considers reliable; PineBridge Investments does not represent that such information is accurate or complete. Certain statements provided herein are based solely on the opinions of PineBridge Investments and are being provided for general information purposes only. Any opinions provided on economic trends should not be relied upon for investment decisions and are solely the opinion of PineBridge Investments. Certain statements contained herein may constitute projections, forecasts and other forward-looking statements that do not reflect actual results and are based primarily upon applying retroactively a hypothetical set of assumptions to certain historical financial information. Any opinions, projections, forecasts and forward-looking statements presented herein are valid only as of the date of this document and are subject to change. PineBridge Investments is not soliciting or recommending any action based on any information in this document.

PineBridge Investments Europe Limited is authorised and regulated by the Financial Services Authority ("FSA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FSA Handbook and has been approved by PineBridge Investments Europe Limited.