THE Weekly View

RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

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Responding to Operation Twist

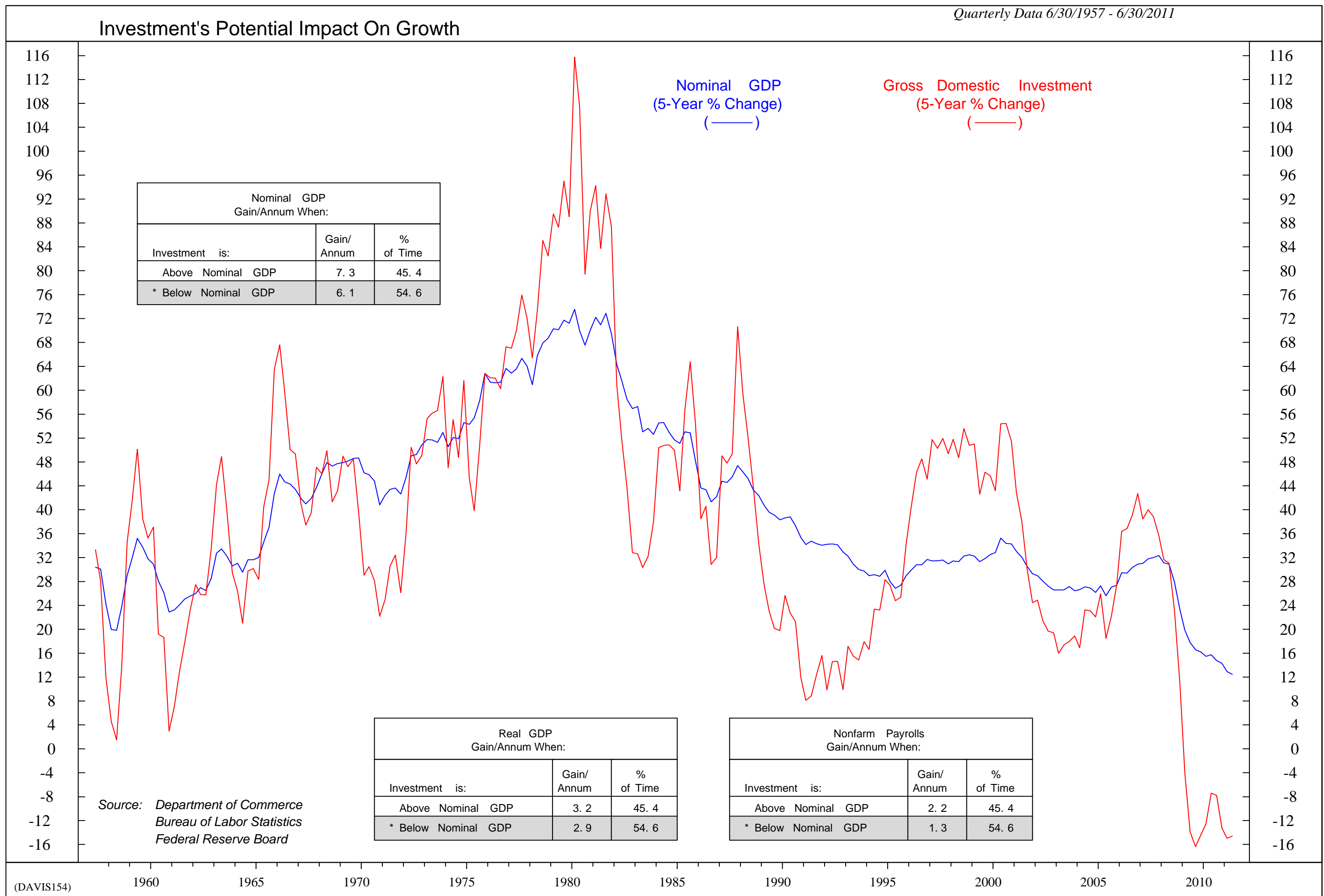
- In order to "help make broader financial conditions more accommodative" and lower long-term interest rates, the Federal Reserve, in a widely anticipated move, announced last week that it would buy $400 billion in 6- to 30-year Treasuries by the end of June 2012, while selling an equivalent amount of 3-year and under Treasuries (where yields are already zero). The Fed's tactic of selling short-term fixed income securities to fund purchases of long-term securities, known as 'operation twist,' together with reinvesting more of its principal payments into agency mortgage-backed securities, is intended mostly to lower mortgage rates for a housing sector that, in the Fed's words, "remains depressed." We expect to see conventional 30-year fixed mortgage rates below 4% as a result, but without legislation that would allow underwater borrowers to refinance, we think its impact will be limited.
- We have been looking for ways to maintain and even raise yields in our more conservative portfolios in response to the Fed's ongoing policy of keeping interest rates low, which has reduced income for all savers. We felt the Fed's latest move presented us with an opportunity. Starting three weeks ago, we began increasing exposure to both long-term Treasury bonds and high-yield bonds, the prices of which tend to move in opposite directions. Thus, our Treasury position hedges some of the downside risks of high yield bonds, and the combination of the two improves our portfolios' overall yield potential.
- We think that the average high-yield bond yield of 8.8% already reflects investor fears of another US recession – our own judgment is that the odds are about 50/50 – and so we regard high yield valuations as reasonable and their yields as attractive. If the economy slows more than we expect or Europe's problems worsen, high yield spreads versus Treasuries could widen further. In this case, we expect Treasury yields to fall and the consequent gain in our long bond position would likely offset some of the price declines in our high-yield position. We chose long bonds as a hedge because short rates are already so low there is little room to fall further. Furthermore, 30-year Treasury yields are still nearly 0.4% above their record lows, offering some price appreciation potential as the Fed shifts its balance sheet to more long-duration bonds and/or economic conditions worsen.

A way but not the will – the saga continues…

German Chancellor Angela Merkel has said that "everything must be done to keep the euro zone together" and declared "Greek default is not an option." Meanwhile, in a joint statement last week, G-20 finance ministers of major economies proclaimed: "We are committed to supporting growth, implementing credible fiscal consolidation plans, and ensuring strong sustainable growth. This will require a collective and bold action plan with everyone doing their part." While recent pronouncements help assure markets that policymakers understand the gravity of the situation – €3 trillion is now being discussed as the necessary size of any workable stability fund – without commensurate actions they risk further undermining their already-tarnished credibility. We are encouraged that policymakers have recognized the scale of the problem, but as we wrote last week, the political will to act has not yet been forged.

As the potential for a Greek default increases, the voluntary bond exchange offered in July (see *Weekly View* 7/25/11) becomes more likely. If enacted, the exchange – which requires 90% participation – would amount to an initial restructuring of Greek debt that we think is necessary to eventually resolve the crisis. As the price of Greek debt has fallen, the terms of the deal (with offers of guaranteed repayment) have become more appealing. However, even if the exchange were conducted, bringing in 'private participation' and loss recognition, it would mostly just extend Greek maturities and do little to reduce the overall debt load. Hence, we would view any debt exchange as only a partial solution, although it could provide a template for future restructurings.

The Weekly Chart: A Matter of Confidence



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US nonfinancial corporations' balance sheets remain in good shape, but business and economic uncertainties are stifling growth. Nonfinancial corporate cash balances and liquid assets are at record highs on an absolute basis ($2 trillion) and relative to net worth (13.6%), while as a percentage total assets (also coincidentally at 13.6%) are nearing the highest levels since 1984. Meanwhile, nonfinancial corporations' net interest payments as a percentage of cash flow are the lowest since the 1950s, effective tax rates are near record lows, and profit margins are near the highs. The chart above shows the five-year change of gross domestic investment (GDI) near record lows at about -15%, well below nominal GDP growth rates. This condition has historically dragged down both real economic growth and hiring (see boxes within the chart). Moreover, GDI has been negative since 2009, which has not happened since the chart begins in 1957 and, we suspect, since the Great Depression. However, as Fed Chairman Bernanke optimistically said last August: "although important problems certainly exist, the growth fundamentals of the United States do not appear to have been permanently altered by the shocks of the past four years. It may take some time, but we can reasonably expect to see a return to growth rates and employment levels consistent with those underlying fundamentals." We believe business confidence is a crucial factor affecting US growth. Business owners have adjusted profitably to below-trend 'new normal' growth, but are unwilling to invest while the macro, regulatory, and political environments remain so uncertain. Thus, while we are cautious about the short term, we think it is wrong to assume, as the bond market currently does, that long-term growth has been permanently reduced.

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