

Market Watch

September 2011 Markus Schomer, CFA — Chief Economist



Even more remarkable is the rally in the Treasury market...

Investment Outlook

The Treasury market has lost its connection to US growth and inflation fundamentals; another reason the Federal Reserve ought to rethink its policy actions. The Fed's extended commitment to keeping rates low, coupled with recession fears have driven two- and five-year yields to new record lows. If we don't slip into recession and if inflation doesn't slow dramatically in the next few months, then Treasuries look very overvalued. However, double dip recession risk has increased dramatically, which will anchor yields at these low levels.

(Investment, continued)

Overview

- + **This is not just a "Soft Patch" anymore.** We are now dealing with an outright "Double Dip" recession risk. What started out earlier this year as a weather/Japan earthquake related temporary slowdown, is now a much more serious policy-induced threat to the economic recovery. In reaction to the rapidly deteriorating growth backdrop, economists are falling over each other in the race to downgrade US and global economic growth projections, and I am no exception. Just 10 months ago I was looking for 3.5% growth in the US for the next three years. My latest forecasts are down to 1.7% for this year and 2.6% for 2012, and I still see more down than upside to those numbers. I have commented on this before, but it is becoming ever more clear that the wrong economic policy is the main reason the US recovery has stalled. If policy doesn't change, I believe recession fears may become reality.
- + **Financial markets had to deal with a number of shocks, most of which were not on our radar screen last year.** The debt ceiling debacle, the S&P downgrade, the sharp increase in recession fears and, of course, the seemingly uncontrollable "Euro Zone Debt Crisis." All of that has created a financial market environment somewhat reminiscent of 2008. Once again, confidence in the solvency of banks is questioned, but this time it is due to the uncertainty over sovereign exposure. What is different this time is that central bank money spigots are open and liquidity is not a concern. The fact that all this coincided with the end of QEII just added to an already elevated level of market volatility.
- + **US stock markets have fallen dramatically since early July, down about 10% in the past six weeks alone.** Even more remarkable is the rally in the Treasury market. Nobody really thought the downgrade would have any noticeable impact. However, I would guess that nobody would have thought 10-year Treasury yields would fall below the levels we saw during the worst parts of the "Great Financial Market Crisis" either. Fixed income credit spreads are generally wider compared to the start of July, but performance has been positive across the board, with only high yield posting negative returns. The US dollar has not been able to improve across the board in the current extremely risk averse environment, losing ground to Swiss franc and Japanese yen. However, the dollar has gained against growth currencies such as the Swedish krona and the Australian dollar.

Economy

I sound like a broken record on this, but the underlying economics still look fine. There is still a lot of pent up demand in both the consumer and business sectors and I have seen no evidence that corporate or household balance sheets have deteriorated any further in recent months.

(Economy, continued)

Policy

The good news is that Congress is on vacation, so our politicians haven't been able to make things any worse. The bad news is that the US debt crisis remains very much unresolved and we need someone to produce another demand stimulus. The unwillingness to compromise has already triggered a ratings downgrade and delegated much of the necessary deficit

(Policy, continued)

Investment outlook (continued)

Our forecast of a Fed rate hike early next year, always more a prescription than a prediction, has been tossed out of the window by the last FOMC decision to extend an open-ended commitment to keeping rates low "for an extended period" to an unprecedented and much more specific promise to leave rates low for the next two years. I strongly believe the Fed will raise rates well before the middle of 2013. However, in the meantime the new policy language serves as another reason that Treasury yields, even at these extremely low levels, have little upside risk. I have lowered my year-end 10-year yield forecast to 2.50% this year and 3.50% in 2012.

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Economy (continued)

What is holding back investment and spending decisions now is uncertainty over future demand on the business side and future income on the household side. I still believe this could be remedied fairly quickly, if authorities in Washington stopped growth depressing fiscal austerity policy and income depressing monetary inflation policy.

However, my confidence in such a policy shift is fairly low. In 2008, the Dow Jones Index fell 2,500 points in the space of two weeks and another 1,000 points in the subsequent month. Right now we are down about 2,000 points in the past four weeks. If you have seen the HBO movie "Too Big To Fail," you remember that the stock market collapse forced then Treasury Secretary Paulson to beg Congress for TARP, but it is tough to determine who would fill that role in a 2011 sequel.

Another reason to remain bullish on US asset markets is the supportive bottom-up view of the economy. Our corporate analysts keep emphasizing very attractive valuations and robust profitability. However, the most coincident macro data are starting to show the damage done to those bullish growth fundamentals. The University of Michigan Consumer Confidence Index fell to its lowest level in 31 years in early August; below the worst levels during the past recession. Regional manufacturing surveys in the New York and Philadelphia areas showed a dramatic deterioration in business activity in August. Additionally, weekly home purchase applications have been declining at a 25% annualized rate over the past four months.

The current slow growth situation is not sustainable. Weaker demand expectations are likely to trigger renewed cost cutting and fresh job cuts, which in turn would further reduce demand expectations. If we don't see a growth rebound soon, we will find ourselves in a growth recession with rising unemployment and elevated inflation.

Policy (continued)

reduction to yet another committee, which must report by Thanksgiving and find another US \$1.2 trillion in deficit cuts. That can only be the beginning, as most experts agree that the combined US \$2.5 trillion in cuts this process is set to deliver is just about half of what is the minimum necessary to put US public finances back on a sustainable path. The problem is that no decision will trigger more near-term austerity and a failure to agree on extending the expiring the payroll tax cuts next year could push the current fragile economy over the recession edge. Listening to politicians of both parties in the past week or so, the jobs crisis is starting to replace the singular focus on debt and the deficit. The lesson from Europe must be that fiscal austerity without a growth strategy doesn't work.

I hope we will be analyzing various proposals to add more stimulus in the next few weeks. One easy way would be to extend and increase the payroll tax cut. Another area where compromise should be achievable is housing, which is starting to show a distressing deterioration. One corner where I hope we won't get more "stimulus" is monetary policy. Interest rates have little to no bearing on credit demand, hence policies designed at lowering rates further up the yield curve will have little to no real economic effect. More "QE" would even be disastrous.

What the Federal Reserve must be realizing now is that in a "Liquidity Trap" with globalized financial markets and deregulated labor markets, monetary policy cannot create the type of inflation that would boost nominal activity. Monetary policy has no impact on growth stimulating wage inflation. All it can create is growth depressing asset price inflation. The monetary policy driven run up in commodity prices earlier in the year was the reason growth in real disposable household income ground to a halt, with inflation all but absorbing a decent 4.2% annual nominal income growth rate. If we can reach consensus that the economy needs more stimulus for it to be effective, then it must come from the fiscal side and not from the Fed.

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WN A2779 (09/2011) J83645

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