



Fixed Income Market Commentary

February 2012



A Reverse Form of Usury?

Usury is defined as excessively high interest that a lender charges a borrower. The term is generally used to indicate the borrower is being treated unfairly.

I can't come up with an exact antonym for usury, but if I could I would use it to describe what the Federal Reserve and Chairman Bernanke are imposing upon savers. Rather than super-high rates of interest, the Fed's actions are imposing crushingly low rates on our rainy-day money and conservative fixed-income investments.

One phrase that comes close is "financial repression," a term which, in part, describes policies designed to direct funds to back to the governments that implemented them. It can also be applied to a government that places caps on interest rates.

What prompts my concern today is the Fed's January statement that it intends to maintain a "highly accommodative monetary policy." In plain English, the Fed has said it doesn't plan to raise interest rates until late 2014. This is good news for borrowers. But savers remain legitimately frustrated by our continuing low-interest-rate environment and the correspondingly low yields on just about anything that pays a rate of return, from cash in money market accounts to the bonds we invest in. I don't see why the Fed had to go that far out on the limb. We know from prior communiqués their intention to stay on hold for another two years. What did they accomplish by extending the period by another year?

Of course, nobody is forcing us to lend to the government, or anyone else for that matter. Still, it feels like abuse at the hands of the Fed, as their policy keeps interest rates painfully low for fixed-income investors. Not everyone minds though. As I said, low interest rates benefit borrowers big-time. The Fed's obvious targets are potential homebuyers. They hope that renters will come to the conclusion that it is cheaper to buy than rent. More buying should boost the moribund housing market, create jobs and by extension lift other areas of the economy, too.

While the news has focused primarily on the negative impact of low interest rates on individual savers, U.S. corporations are beginning to feel the squeeze, too. Last year's minimal stock market gains left many pension funds trailing their assumed rates of return (generally in the 7% to 8% range). Companies from Boeing to GE to Alcoa have had to make larger contributions to keep their funds sufficiently funded. Low bond yields are only exacerbating the problem for the pension funds' bond holdings. A continued need to fund pension accounts beyond expectations could eventually impact earnings.

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This has me wondering what the Fed's rationale for its low-interest rate policy is, and whether they know something we don't (the Fed's data has got to be better than anyone else's). What are they worried about?

Whether it's the slow pace of our own economic expansion, the uncertainties surrounding the euro-zone crisis, or something else, I can't be certain. I do know that their policies may be helping borrowers, but it sure is hurting savers. I call that usury in reverse.

Market Review

January was a pretty good month for investors all around as both stocks and bonds performed well. In the Treasury market, there was a continuation of the theme we saw much of last year. Treasury Inflation-Protected Securities (TIPS) soundly outperformed nominal Treasuries. The TIPS index was up 2.3% versus the Treasury index's 0.4% gain.

Barclays Fixed Income Index Returns Through 1/31/12						
	Duration	Jan.	YTD '12	Return '11	Return '10	Return '09
US T-Bill Index	0.33	0.00%	0.00%	0.15%	0.22%	0.37%
US Treasury Index	5.85	0.42	0.42	9.81	5.87	-3.57
US TIPS Index	4.65	2.29	2.29	13.56	6.31	11.41
US Aggregate Bond Index	4.86	0.88	0.88	7.84	6.54	5.93
US Govt / Credit Index	6.00	1.07	1.07	8.74	6.59	4.52
US Credit Index (A2)	6.82	2.08	2.08	8.35	8.47	16.04
US High Yield Index (B1)	4.10	3.04	3.04	4.98	15.12	58.21
Caa component	3.62	3.75	3.75	1.18	16.43	90.65
Emerging Market (\$\$) (BA1)	6.53	2.34	2.34	6.97	12.84	34.23
Municipal Index	7.44	2.31	2.31	10.70	2.38	12.91
Municipal Index - 5 Year	3.92	1.03	1.03	6.93	3.40	7.40

Source: Barclays Capital

In the risk market (i.e. high-yield bonds) it was "risk-on" again. Strong **high-yield** bond performance (3.0%) was led by the riskier component of that market, which returned 3.7% even as it saw its first default of the year from Eastman Kodak. The **emerging markets** (2.3%) sector saw good performance too, and many of the central banks in those countries are looking toward easing rates and being more accommodative. The market saw a handful of billion-dollar bond offerings coming from Romania, Lithuania, Peru, Turkey and Colombia, and each found willing buyers.

Finally, the January effect in the **municipal bond** (2.3%) market helped that sector. Every January, a slew of bond maturities, redemptions and interest payments put cash back into the hands of investors, who typically turn around and reinvest those proceeds in additional bonds.

All in all, it was a pretty nice way to start the year for investors of all stripes.

Christopher Keith
Senior Vice President
Fixed Income Manager

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