

Market & Investment Call Recap

The bond market is starting 2012 where it left off in 2011—uneventful, ignoring any positive economic data and keeping a wary eye on Europe. With the next official comments from the Federal Reserve expected to reconfirm their stance on maintaining the current low interest rate environment, it looks like we are in store for more of the same lackluster yield moves. As for the numbers, the two-year Treasury note yield remains where it closed 2011, at 0.25 percent, while the 10-year note is seven basis points higher at 1.95 percent.

The new year is not bringing any clear answer to the conundrum of the financial markets. We continue to fight the battle between the Fed and the economy. In any survey of economists, traders and investors, there is a clear divergence on what will move (or not move) the markets this year. Most economists are betting on higher yields resulting from steady improvement in the economy, while traders (who tend to sway market movements with heavy-volume trading) are convinced the demand for safety will win out, forcing yields to remain at low levels.

The demand for Treasury securities was obvious at the first Treasury note auction of the year this week. The sale of \$32 billion in three-year notes had the highest bid-to-cover ratio (3.73 times) on record for a three-year note, indicating strong overall demand. If you think it was the outstanding rate of 0.37 percent that attracted buyers, you need to think again. Despite being downgraded in August 2011, U.S. Treasuries are still considered the safe haven investment in the world and will continue to attract dollars.

The Fed has the trump card on interest rates. Their actions present a pessimistic outlook on real economic progress and seem to reflect a desire to keep rates low, possibly into 2014. Estimates on where the 10-year yield will close in 2012 vary from an average of 2.20 to 2.80 percent, depending on who you listen to. As long as the Fed keeps rates low on the front end, the market will do little outside of Fed projections.

A good example of how a steady Fed Funds rate can affect longer-term yields is seen in the yield valuation of the 10-year note. The difference between the 10-year yield and the Fed Funds rate is currently 170 basis points. By comparison, the average difference over the past 20 years is 163 basis points. In other words, the 10-year yield is close to fair value now. Without any interest rate move from the Fed, yields have little chance to move significantly higher based on value.

The question we are faced with now is what to focus on in 2012. First up is the Federal Reserve, which seems to have more control over interest rates than necessary. Fed Chairman Ben Bernanke is continuing his mission of wanting to take the mystery out of the market. Beginning this month, the central bank will release quarterly forecasts for interest rates. The Fed says the move will help remove some uncertainty from the market and provide transparency into their thinking. The next FOMC meeting is January 25, at which some analysts think the Fed could announce an extension until 2014 for keeping interest rates low or even introduce a Quantitative Easing 3 program. Either move would inactivate the interest rate game and force yields to remain near current levels.

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The state of the economy is also front-and-center, but may not get the reaction expected, as is evident from last week's employment report. With a solid gain of 200,000 jobs and the unemployment rate at its lowest level in almost three years, the market all but ignored the news. Manufacturing has remained stronger than most sectors of the economy during the recovery and will probably remain stable through the first quarter due to inventory rebuilding. Housing continues to be the weak link, showing small signs of improvement, but not enough for anyone to declare victory.

The Fed has been very vocal in recent days concerning housing. New York Fed President William C. Dudley said last week that "additional housing policy interventions" are needed to boost growth. Other comments by Fed policymakers suggested that the U.S. government should consider new ways to spur the housing market. These comments left analysts thinking the Fed may not have many tools left to boost growth and that creating housing demand is crucial in order to spark life in the economy.

Lastly, Europe will remain in the background throughout the year. After sovereign and bank downgrades, bailouts of Greece, Ireland and Portugal, and countless revisions of debt restructuring plans, Europe is no closer to resolving its financial crisis. Most recently, Greece is in the final negotiations to persuade investors to settle for 50 cents for each euro the government borrowed. This would be the euro area's first large-scale restructuring. At the same time, German Chancellor Angel Merkel met with French President Nicolas Sarkozy to discuss the region's debt crisis. Some progress was made at the meeting, but final reconciliation is a long way off.

INVESTMENT STRATEGY

Unfortunately, the new year did not bring new and better investment choices. We still have the same certificates of deposits and agency securities to choose from. Making matters worse will be continued shrinkage of the supply of agency debt structures. With demand for investment paper still strong, the agencies will be able to issue at narrower spreads, and thus, lower yields.

The key to maintaining your sanity and an income-producing portfolio is going to be more selective choosing and protection. With the Fed "promising" to keep rates low for at least 18 months, you might as well buy the callables with longer lock-out dates. Yields are not much different between three-month and one-year call protection, so save yourself the aggravation and rate risk of constant reinvesting.

There is hope and a good chance that the rampant liquidity many experienced in 2011 may ease a bit as the year progresses. Some credit unions were already experiencing lower levels of cash during the last few months of the year. Less cash will allow you to better fit your investments to your ladder, rather than feel the need to just spend the money. Take a look at your call and maturity dates, and use this year to fill in gaps.

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MARKET RECAP

For the week of: 1/9/2012							
	<u>US Treasuries</u>	<u>SimpliCD CD</u>	<u>Agency Bullets</u>	<u>Agency Step-Ups (YTC/YTM)</u>	<u>Agency Callables</u>	<u>Agency MBS (Ave. Life)</u>	<u>Agency CMO's (Ave. Life)</u>
6 months	0.05%	0.22%	-	-	-	-	-
1 Year	0.09%	0.51%	0.14%	-	-	-	-
2 Years	0.25%	1.05%	0.36%	-	-	1.13%	1.49%
3 Years	0.37%	1.50%	0.58%	.55%/.87%	0.65%	1.87%	1.54%
4 Years	-	1.65%	0.95%	.5%/1.45%	1.05%	1.98%	-
5 Years	0.87%	2.00%	1.13%	1.02%/1.49%	1.34%	-	-

Rates shown are indications of the category and term and not a specific bond. The term shown for comparison purposes is maturity for all securities except MBS and CMOs where average life is shown.

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Index	12/30/11	1/9/12
1 month LIBOR	.29	.30
2-yr SWAP spread	48bps	40bps
2-yr Agency spread	6bps	6bps

Treasury Yields	12/30/11	1/9/12
6 mth TBill	.06	.04
1 year note	.10	.09
2 year note	.24	.24
5 year note	.83	.84
10 year note	1.88	1.95

SimpliCD	12/30/11	1/9/12
6 mths	.22	.22
1 year	.52	.52
2 years	1.10	1.05

Date	Economic Report	Forecast
1/12	Retail Sales	0.3%
1/18	PPI	0.1%
1/20	Existing home sales	4.1%

Please contact the Investment Services Group at 800.442.5763, option 4 if you have any questions or concerns.