Market & Investment Call Recap

The bond market saw very little action the past two weeks, as the markets appeared to be on hold for this week's Federal Open Market Committee (FOMC) meeting. The two-year note yield remained at 0.24 percent while the 10-year note yields edged higher by eight basis points to 2.06 percent. The stock market did not fare much better, adding only 254 points during the period.

January seems to be a month where everyone is hunkered down, putting the financial books of the previous year to bed. This was obviously the situation across the board this year, because even the best of economic reports was ignored. On the whole, the economic data reported the past couple of weeks paints a fairly optimistic view on the economic recovery as we enter 2012. And while not all positive, the reports do outline areas where improvement is occurring. Inflation rates are being reported well within the Federal Reserve's comfort zone. Headline inflation has now failed to register a positive reading for three straight months. Manufacturing continues to be the shining strength to the economic expansion. Even the weekly jobless claims fell to its lowest level in four years, declining 50,000 during the second week of January.

The housing sector continues to struggle and is full of mixed signals. New completions were up month over month last month, and compared with December 2010, all three measures—permits, starts and completions—are higher. Existing home sales rose by five percent at the end of the year with overall sales up 1.7 percent for 2011. But the foreclosure issue still poses a lot of uncertainty. Some analysts speculate that a reduction of foreclosure filings may be swaying the current sales figures. The number of properties receiving notices of default, auction or repossession last year fell 34 percent to the lowest figure since 2007, but analysts estimate there are roughly14 million distressed properties that need to be addressed before the housing crisis is over.

As European leaders continue to find the right blend of strategies to end the debt crisis overseas, it feels like déjà vu, but this time in Europe. The euro banks seem to be where the U.S. banks were a few years ago. In an effort to spur growth in Europe while correcting the severe debt crisis overseas, the European Central Bank (ECB) lent €489 billion ($625 billion) to European banks in December. The governments' intentions were to encourage the banks to lend money to companies and consumers, but instead the banks have chosen to use the cheap loans to refinance or pay down other borrowings. Just like we saw in the U.S., the banks would rather trim their balance sheet rather than raise an additional €114.7 billion in core capital required by the governments.

Another unintended effect of the government lending program has been a significant decline in European sovereign debt yields. The banks realized the cheap ECB loans presented a great spread trade by allowing them to reinvest the borrowed funds into higher yielding government debt. This renewed buying brought yields down dramatically, giving the appearance of some stabilization overseas. Italian two-year debt fell to 3.90 percent from its peak of 7.80 percent in November. Spain's two-year debt fell to 3.30 percent from a high of 6.20 percent.

After sending warnings of sovereign debt downgrades, Standard & Poor's announced late on Friday the 13th its actions affecting 16 nations. Of the 17 members of the euro area, nine had their credit ratings cut. France and Austria lost their triple-A rating by one notch to AA+, while Italy, Portugal and Spain were downgraded two notches. This move puts Portugal at BB, considered junk status. Germany was affirmed at triple-A and was one of only two countries confirmed with a stable outlook. The remaining 14 countries have a negative outlook. And just like in the U.S. when S&P cut our debt rating, yields in Europe barely responded to the news.

Greece continues to resolve its debt restructuring issue before March, when a large interest payment on its outstanding debt is due. The country needs to cut about a third of its debt, around $129 billion. At issue are the terms of the restructuring, including the interest rates to be paid, the longer term of the bonds and how much the euro-zone countries will lend to Greece as part of the deal. Despite trying to find a resolution last week and throughout the past weekend, the impasse remains and will be a main topic at this week's meeting of the euro-zone ministers in Brussels.

While the euro problems are still unresolved, U.S. bond yields began to move higher in the longer end of the curve late last week. The 10-year Treasury moved above 2.00 percent for the first time since mid-December. This could be construed as a sign that investors see some glimmer of hope on the horizon and may be willing to take more risk. For stock lovers, this could translate into rising prices. For credit union investors, it still means yields in the short end won't have much room to move—as long as the Fed sticks to their current mandate.

Turning to the U.S., this week's FOMC meeting will be the highlight. The meeting is expected to release new information that could put a damper on the markets. From what the Fed has commented on briefly last month, the meeting will be focused more on refining its communication plan than real monetary policy. The central bank is planning to announce a revised communications strategy, including more information about interest-rate projections and objectives for inflation and jobs. The Fed has said it will lay out what each Fed District bank projects the Fed Funds Target rate will be each year through 2015. There is a lot of debate over whether this information will help or hurt the markets. Many investors and analysts think this will only handcuff the yield curve and probably cause it to flatten, while others hope that just getting some information will unlock the stalemate situation.

ECONOMIC DATA

Retail sales: Sales at U.S. retailers in December rose less than forecast, restrained by cheaper fuel prices and early holiday discounting that helped keep down the value of goods sold. Economists projected an increase of 0.3 percent versus an actual increase of 0.1 percent. The figures show that spending eased at the end of the fourth quarter, and may indicate that purchases will remain low early this year.

Manufacturing: The NY Empire State Index, a report on manufacturing in the New York, New Jersey and Connecticut areas, rose to 13.5 from the previous measure of 8.2 in December. This is the third consecutive increase and the highest level since April 2011. The increase is a good reflection of the continued demand for manufactured goods in the U.S. Pressure could occur from Europe in the near future, though, as the euro continues to lose value.

Industrial production rose 0.4 percent in December. Manufacturing production rose a solid 0.9% in December following November's surprise 0.4 percent decline. Details show output of motor vehicles and parts up 0.6% and non-auto output up 0.9 percent, the biggest gain since the same month in 2010. Outside of manufacturing, mining output rose a modest 0.3 percent, while utilities output plunged 2.7 percent, mostly attributed to the unusual warm winter weather. Overall, the report affirmed that November's decline was more than likely an aberration and that manufacturing has good momentum entering into 2012.

Inflation: Producer prices fell 0.1 percent in December, the second drop in three months. A continued decline in the finished energy goods index and a reversal in the finished foods index, that had been rising smartly, contributed to the drop in the overall finished goods index. Prices in the earlier stages of production declined as well, which signals further rounds of weak producer and consumer price inflation.

Market & Investment Call Recap

In line with the wholesale price report, the consumer price index (CPI) was unchanged in December. A decline in the energy index once again weighed heavily on headline inflation. The core CPI rate moderated to a tepid 0.1 percent increase as vehicle and apparel prices declined. These readings give credence to the expectation that core inflation has probably peaked near term.

Housing: Housing starts, or New Residential Construction as it is officially known, came in lower than expectations. Housing starts declined in December to a seasonally adjusted rate of 657,000 units, 4.1 percent below the November estimate; permits also slid. Despite the backward slide in the top-line number, residential construction's slow upward trend remains in place.

Existing home sales are slowly climbing out of their mid-year slump, rising to their highest level since January 2011. Sales increased 5.0 percent in December compared to November, about on par with market expectations. December marks the third consecutive month of gains, the longest string in approximately a year.

Inventory for December dropped 9.2 percent with the number of units for sale at the lowest level since March 2005. The number probably reflects the shrinking inventory of listings as much as improved sales. Home prices remain a weak spot in the housing cycle. While the median price of a home declined in December by 2.5 percent from a year ago, some analysts predict prices could fall another five to six percent before bottoming out.

INVESTMENT STRATEGY

The investment experience in this subdued interest rate environment teeters between boredom and frustration. While the market is waiting for the FOMC meeting to incite some activity, the more likely scenario is just more of the same—interest rates will be held hostage for a longer time period of time, with very little room to move higher.

Adding to the problem is finding adequate short-term investments. To start with, neither the GSEs nor the banks have a high demand for funds. On top of that, most borrowers are going to take advantage of the flattening yield curve and issue longer-term debt. We are already seeing this with FNMA and FHLMC debt issuance the past couple of weeks. In the past week, only 28 percent of the bonds issued were under five years. FHLMC has estimated that only 50 percent of their issuance this year will be in callables, compared to 58 percent last year and 70 percent in 2010. FNMA will probably follow the same route. Unfortunately for investors, this translates to tighter spreads and lower yields.

It still will be prudent to continue investing your excess liquidity, even if it means adding one-year CDs at 0.40 percent. There have been a few agency bullet bonds priced that can be used to fill gaps in your ladder. Call protection remains important, and you really are not giving up much yield in this market. We are beginning to see a re-emergence of step-up structures that are a worthwhile choice. When analyzing the step-ups, be sure to consider the front end coupon and how long it lasts, as well as your overall yield to maturity.

MARKET RECAP

Index	1/10/12	1/24/12
1 month LIBOR	.30	.28
2-yr SWAP spread	37bps	34bps
2-yr Agency spread	6bps	5bps

Treasury Yields	1/10/12	1/24/12
6 mth TBill	.05	.06
1 year note	.09	.10
2 year note	.24	.24
5 year note	.85	.91
10 year note	1.97	2.06

SimpliCD	1/10/12	1/24/12
6 mths	.22	.22
1 year	.52	.50
2 years	1.10	.95

Date	Economic Report	Forecast
1/25	FOMC announcement	0% -.25%
1/26	Durable Goods Orders	2.0%
1/27	GDP – 4Q11	3.0%

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