THE BUTTONWOOD

On May 17, 1792, twenty-four merchants gathered under a buttonwood tree at 68 Wall Street. There they signed the Buttonwood Agreement, creating the first investment community, which later evolved into the New York Stock Exchange.

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SECOND QUARTER 2012

Henry J. Wildhack II
Matthew J. Abbott
Melissa M. Heywood

110 West Fayette Street
One Lincoln Center
Suite 900
Syracuse, New York 13202

(315) 701-6452

Early Fireworks

The fireworks that we all anticipate this time of year were abundantly evident in the financial markets as the second quarter 2012 came to an end. In fact, one might argue that the fireworks were in evidence for the entire month of June as the DJIA, S&P 500, and NASDAQ posted gains of 6.28%, 6.58% and 6.83% respectively for the month. While each index is still below its 2012 high, year-to-date returns fall in the solid, if not great, category. Further evidence of this solid performance is the S&P Small and Mid-Cap Indices both posted similar gains. In each of these cases the gains are impressive when one considers that in early June most or all of the year-to-date gains for each index had disappeared.

While foreign markets did not post year-to-date gains as strong as the US indices, they also rallied from mid spring lows to post impressive gains in June. The Dow Jones Global Index, the STOXX Euro 600, and Dow Jones Asia Pacific had gains of 6.77%, 6.83% and 5.03% respectively. These June gains are especially impressive when one considers the well-publicized problems facing the European Union (EU).

Looking toward the rest of 2012 the obvious headlines will include the EU, the US presidential election and the budget battle on Capitol Hill. Economic growth, domestic and abroad, presents a mixed picture.

With respect to the US economy, consensus growth estimates fall between 2.0% and 2.3% this year and slightly higher (2.6%) in 2013. The US is still in the process of deleveraging the real estate bubble – a process that requires time. After the process is complete the US consumer won't be as large a variable in economic growth because a large part of past growth included record cash out refinancing from 2003 to 2008. In dollar figures it is estimated that this equaled 2.3 trillion dollars according to the McKinsey Global Institute. Another significant variable in the real estate bust is the negative collateral effect it has had on those industries that are dependent on home building or housing sales. As we mentioned above, all of this takes time.

Another concern with respect to US growth is the "policymakers" (our emphasis) and what decisions they might make. Federal Reserve policy seems intent on keep interest rates at historic lows to stimulate the economy. The risk is that this might sow the seeds for inflation in the next several years. Fed policy has benefited from lower commodity prices so at this time inflation isn't a concern. That will probably change in the future.

The elected policymakers will have a more significant near term and secular (long term) impact on the direction of the economy. In the near term, the US runs the risk of falling off the fiscal cliff that has made so many headlines. A recent report issued by PIMCO estimates that tax increases and spending cuts due in 2013 would likely result in GDP contraction of 4% with economic growth of 2%. PIMCO states that this scenario would almost certainly cause a recession in 2013. We can only hope that both sides of the aisle will recognize that they have ample time and several viable options to find a satisfactory common ground or compromise.

What form this compromise takes will affect the secular outlook. The best scenario would be if both sides come up with a solution that gives consumers and investors a level of confidence that suggests that taxes and deficits won't derail economic growth.

The global picture, especially Europe, is muddled to say the least. Goldman Sachs states that the European periphery (Spain, Portugal, Greece and Italy) is in a recession. The northern European nations are faring better but the divergences between the core and the periphery make a meaningful recovery doubtful. Goldman goes on to say

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that they do not look for a meaningful improvement from Europe in general.

A larger problem might be the severity of the debt crisis that grips Europe and the effect it might have on the very foundation upon which the union was created. A recent article in ***The Economist*** (July 2012) mentioned that the European Union was created to ***"end chronic and divisive currency crises, promote growth and multiply Europe's economic power. After the creation of the single market, the euro was the next step toward political union"***. The current crisis has overwhelmed Europe's leaders and is testing the resolve of the union's political will. Again quoting ***The Economist*** ***"…hope of forging a common European identity has given way to greater national assertiveness…anti-EU parties are gathering strength…Greece has seen a sharp rise of parties of the far right and far left…some Greeks depict German leaders as Nazis…many Germans regard Greeks as lazy".*** While evidence suggests that this sentiment is very likely on the far edge of the spectrum it is, nonetheless, unsettling. How these political realities affect the Union will be critical.

Bonds On The Run

Recently much has been written about the bond market and the prospects for a bond market bubble. Certainly there is some merit to concerns of a bubble. Consider –***The Wall Street Journal*** (7/2/12) reported that in the 2nd quarter investors took $44 billion from stock mutual funds and bought $71 billion of bond funds, since 2007 $350 billion has flowed out of stocks and $1 trillion has flowed into bonds. Finally, in 2005 investors held 55% of their portfolios in stocks and 15% in bonds, today those figures are 45% stocks and 25% bonds.

Even more compelling is that the real rate of return on bonds is flat to negative. This last occurred in the late 1970's – early 1980's. It is interesting to take a closer look at what happened then and what is happening now.

In the late '70's – early '80's the rapid rise of the inflation rate was the reason that bond returns went negative. This increase in the inflation rate was significant and unexpected. In most cases investors were caught with bond coupon rates that were lower than the eventual inflation rate – hence a negative real return. Once the Federal Reserve decided to raise interest rates to combat inflation bond portfolios took another hit as values for many bonds declined. The key element here is that this was largely unexpected.

In 2012 the situation is significantly different. Bond investors are willing to accept real negative returns and the possibility of a substantial decline in bond portfolio values once interest rates rise. The Federal Reserve is keeping rates low to boost the economy. Investors (individuals, institutions and foreign governments) continue to buy US bonds because they are viewed as a safe haven and because of the uncertainty and perceived risk in stocks. The key variable to watch for is when the Fed changes policy and raises rates.

What can bond holders expect? I retrieved a January 1995 letter I sent to clients reviewing the 1994 bond market. Before I go further I should mention that 1994 was the worst year for bonds in over 50 years. The bond market was overvalued (not as much as today) and the Fed had raised the prime rate from 6% to 8.5% impacting bond prices. The price of the 30 year Treasury bond fell by 17%, the municipal bond market was down 19% and quality corporate bonds tumbled 13%.

Will there be an exact repeat of 1994 once interest rates rise? No one can predict for certain. We can state, with certainty, that bond prices will go down. (Please note that we are not commenting on the debt issuer's ability to make interest payments or repay principal.)

Is this a bond bubble? There is a great amount of debate regarding this. Those who insist that this is a bubble cite data similar to what is presented above. Those who say it's not contend that bond prices are going up because the Fed has lowered interest rates to all-time lows. They argue that this is a Federal Reserve policy issue and that it lacks the frenzied, speculative buying that typically accompanies a bubble.

We will leave the causes to those who wish to debate. We will also state with certainty that the bond market is due for a meaningful correction. It is very likely to be triggered by higher inflation and increasing interest rates. The best advice we can give is to keep maturities in the short to intermediate range if you can. If you need higher income then you will have to extend your maturities and in so doing be subject to greater price fluctuations. Finally and most importantly, an investment grade bond portfolio (which you have) will weather the storm and you will receive your interest payments and the repayment of principle at maturity.

As always please call, email or text us with questions, concerns or comments.