3rd Quarter 2011 Economic Commentary

2008 redux? That was the question plaguing investors during 3Q'11. Risk aversion was the theme as Europe's sovereign debt crisis rocked financial markets and threatened a global recession. Equities sold off, credit spreads widened, and Treasury yields hit record lows as investors hunkered down to see how the European credit crisis would play out.

The events in Europe drove headlines during the quarter. Greece continued to teeter on the brink of default, and concerns of the contagion spreading to Italy and Spain intensified. As a result, European banks faced limited access to short-term funding as money market funds shed exposure and funding in the interbank lending market tightened. Despite international pressure on Europe to end the crisis, European leaders have appeared lax in their sense of urgency to devise a solution. Negotiations among the 17 euro countries have been frustratingly slow, fueling uncertainty in an already fragile market. Almost three months after first being announced, the revamped version of the European Financial Stability Facility (EFSF) was finally passed by all euro participants in October. The expanded powers of the 440 billion euro fund include the ability to buy the debt of stressed euro-area nations, aid troubled banks in the region, and offer credit lines to governments. The enhanced EFSF was a step in the right direction, but markets are awaiting a more conclusive resolution to the crisis. With pressure mounting, German Chancellor Angela Merkel and French President Nicolas Sarkozy vowed to devise a plan by the November G-20 summit that would create a "durable solution." Until then, market volatility will remain the norm.

While the world focus remained on Europe, the U.S. had its fair share of headlines during the quarter with the deficit and debt ceiling debates and the downgrade of U.S. Treasuries by S&P. Despite the headlines, investors took comfort in owning U.S. obligations as they were the least risky of alternatives, and the flight- to-quality trade drove Treasury yields to new record lows. On the economic front, the U.S. continued to struggle with high unemployment and a depressed housing market. Concerns of the U.S. falling back into recession prompted calls for additional fiscal and monetary stimulus. In response, President Obama announced the American Jobs Act in September. Proposals under the$447 billion act include expansion of the payroll tax cut, new tax cuts for small businesses, infrastructure spending, and reforming unemployment insurance. As expected, political debate over the plan has been intense, and it remains to be seen if any version of the act will ultimately pass Congress.

The Fed stepped up to the plate on easing monetary policy with the announcement of Operation Twist at the September FOMC meeting. While not as aggressive as another round of quantitative easing, it was a step in that direction. Under Operation Twist, the Fed will simultaneously sell short duration Treasury securities from its portfolio and use the proceeds to purchase longer-dated Treasuries. The operation will total $400 billion and last through June 2012. According to the Fed, the goal of Operation Twist is to "put downward pressure on longer-term interest rates, making broader financial conditions more accommodative." The Fed also announced the resumption of agency mortgage-backed security purchases. These actions aim to support the struggling mortgage market, but it is uncertain if lower mortgage rates will be enough to stimulate borrowing given tight underwriting standards, declining home values, and low levels of home equity for many households.

Although U.S. monetary and fiscal policy remains accommodative, upheaval in global financial markets presents significant downside risk to already weak economic growth. As such, all eyes remain focused on Europe. Until a definitive resolution to the sovereign debt crisis is achieved, the fate of the U.S. and global economies will remain mired in the European abyss.

Any opinions herein, including forecasts, reflect our judgment as of this date and are subject to change.