4th Quarter 2011 Economic Commentary

The European sovereign debt crisis continued to dominate headlines and drive market sentiment during 4Q'11. Every successive meeting among the EU leaders perpetuated the cycle of hope and despair that has become the trademark of the crisis. Anticipation built heading into the December EU summit as investors hoped for a definitive solution to ease the sovereign debt strain. While European policymakers committed to work toward a stronger economic union through a new fiscal compact, the summit offered few concrete measures to stem the fiscal crisis. As a result, S&P determined that policy initiatives were "insufficient to fully address ongoing systemic stresses in the euro zone" and downgraded nine euro zone sovereigns (including France by one notch to AA+) as well as the European Financial Stability Facility (also one notch to AA+).

On a positive note, it appears progress has been made in quelling the European bank funding crisis. At the beginning of December, the Fed, in coordination with the ECB and four other central banks, lowered the cost of emergency dollar funding for foreign banks. The move will increase the flow of dollar liquidity to European banks, which have struggled to obtain short-term funding from U.S. money market funds during the crisis. The ECB also moved to support the European banking system by cutting interest rates and unveiling a new Long Term Refinancing Operation (LTRO), which allows European banks to borrow unlimited amounts for as long as three years. The expectation was that European banks would borrow at low rates and use the funds to buy higher-yielding European sovereign debt. However, it appears that many banks are holding onto the loan proceeds to refinance their own debt. As a result, the move has helped to ease European banks' liquidity problems but has done little to alleviate sovereign funding issues thus far.

The ongoing European saga overshadowed some positive developments on the U.S. economic front during the quarter. Labor market conditions improved as positive job creation led to a decline in the unemployment rate. In turn, consumers became more optimistic and spending picked up. Even the housing market showed signs of stabilization as home sales rose and housing starts increased. Despite these improvements, the U.S. recovery has a long way to go. Broad economic growth remains relatively modest, unemployment remains high, and housing inventories remain elevated. However, we appear to moving in the right direction.

Modest improvement in U.S. economic conditions combined with continued uncertainty surrounding the European situation once again drove investors to the safety and soundness of U.S. Treasuries. Even the failure of the Super Committee to reach agreement on $1.2 trillion in spending cuts and/or revenue increases to the federal budget had little impact on Treasury yields. While the U.S. may have its own fiscal problems, its securities are still considered the investment of choice for risk-averse investors.

While acknowledging that recent U.S. economic results were stronger than expected, Fed officials remain wary that the unresolved fiscal crisis in Europe presents an ongoing threat to financial stability and overall growth. As a result, the Fed continues to expect that economic conditions "are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013." Although policy stance remained unchanged at the December meeting, the Fed did announce a change to its communication policy. Beginning in January 2012, Fed officials will add a year-end projection for the fed funds target rate to their forecast table. In addition, each participant will report their projection of "the likely timing of the first increase in the target range" and "qualitative information" about their expectations for the Fed's balance sheet. The move should improve transparency and better align market expectations on rates with those of the Fed.

So while an accommodative Fed will help support the ongoing U.S. recovery, much depends on the outcome of the European sovereign debt crisis. Will the euro zone get its fiscal house in order in 2012 or will it be 2011 redux? Stay tuned…

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