Monthly Economic Update & Market Review September 2011

Investment Strategy Committee

as of
September 2, 2011

BMO Asset Management U.S.
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Summary of Current Views:

August was a tough month. First an earthquake, then a hurricane, followed by power outages and flooding. As the east coast rattled and rolled, so too did the financial markets, as trillions of dollars of wealth was lost in a matter of weeks. Maybe it was simply exhaustion, but the markets found calm heading into the Labor Day holiday.   Persistent downbeat news impacts the confidence (or lack thereof) of nearly everyone (except Warren Buffett). Business and consumer confidence readings are back in the dumps and at least part of the blame lies with the slow pace of economic growth and hiring. With U.S. GDP growth averaging just 0.7% in the first half of the year and expectations only marginally better for the second half, it's easy to understand the disappointment and concern. Growing at such a slow pace leaves little room for unexpected shocks (although by now they should be expected). And no one, understandably, really wants to mention the "R" word again, particularly not this soon after the last event, but the risks of recession are rising again. That risk, of course, is what the markets began to price in, if not fully reflected, in the recent selloff.   At its low in August before rebounding a bit, the S&P 500 had fallen 17% from its July high, with small-caps, mid-caps, and emerging markets down even more, even into bear market territory.

Europe deserves much, if not most, of the blame for this recent turmoil. Policy makers there have not yet found THE big solution that allows them to get in front of the markets for more than just a few days it seems. While S&P might think the U.S. political process is dysfunctional, they seem to be giving the lack of institutional structure and power in the midst of a crisis across the pond a relative pass – not that we are wishing more ill from the rating agencies on the markets. Unfortunately, the stakes for investors are getting higher at a time when many would prefer to reduce risk. Europe's problems no longer involve just the smaller nations of Greece, Ireland, and Portugal. While their challenges have not gone away, the focus has now turned to Spanish and Italian sovereign debt. Too much debt and too little growth are the easily defined problems, but the solutions that many increasingly see as a way out of the crisis are messy and painful. Ultimately, it's possible that one or more nations may leave the monetary union, and one or more sovereign defaults may occur.

Meanwhile, back at home, we wait… Ed Hyman from the research firm ISI put it well recently when he outlined how we waited months for resolution on the debt ceiling debate. Then we waited for the over-hyped Jackson Hole speech from Ben Bernanke. Now we await the September jobs plan President Obama has promised. After which, we will be waiting until November for the Joint Commission (the "super-committee") to identify and (hopefully) agree to at least $1.2 trillion in budget cuts. And if agreement is reached, then we wait for the up or down vote in Congress in late December on the Commission recommendations. Finally, we then wait for the outcome of the long 2012 election cycle.   In the past, markets often preferred when very little was getting done in Washington, but that has changed. Until companies and investors have greater confidence and clarity, they're likely to seek shelter from the storm.

The current environment - at a glance…

Spotlight – pg 5 The federal government has two major policy levers: monetary and fiscal policy. In his recent Jackson Hole speech Fed Chairman Bernanke made clear the Fed will continue to use all the tools available to help boost growth, but they can't do it alone – they need help from the fiscal side. President Obama is scheduled to outline a jobs plan in September that should begin the debate on that front.	**Large Cap Equities – pg 11** The S&P 500 Index fell 5.4% in August to extend the monthly losing streak to four consecutive months. The market was especially volatile following the U.S. debt downgrade by S&P. Lack of investor confidence is demonstrated by steadily declining P/E ratios. Directionally, the equity markets will look for guidance from the coming earnings season, starting officially in mid-October.
U.S. Economic Growth and Inflation– pgs 6 & 7 Growth was revised to a 1.0% pace in 2Q from 1.3% and at just a 1.5% pace YoY. History suggests that when YoY growth slows to less than 2.0%, the risk of recession rises significantly. The manufacturing sector has slowed in recent months and both consumer and business confidence has slipped.	**Mid- and Small-Cap Equities – pg 12** Small stocks posted their third worst August ever, declining 8.7% as volatility spiked on increased fears of recession. YTD small-caps lag large-caps by almost 5%. Energy was the worst performing sector while Utilities rose in value and Consumer Staples held in the best. Mid-caps fell less, but a still painful 6.9% decline.
Employment – pg 8 The July payroll report was better than June's, but still disappointing. 157,000 private sector jobs were added, up from 57,000 in the prior month, but government payrolls shrank by 37,000. The unemployment rate fell to 9.1%, but would be rising were it not for the decline in the labor force participation rate. Initial jobless claims have been steady.	**Fixed Income, Taxable – pg 13** The downgrade of the U.S. debt to AA+ by S&P had little impact on rates as yields instead fell sharply on weaker economic news. The announcement that the Fed will be on hold for at least two years also helped lower rates. Corporate yields rose, however, as they significantly underperformed Treasuries.
Housing – pg 9 The pace of both existing and new home sales fell in July, which boosted the inventory of existing homes to 9.4 months from 9.2. The correlation between household debt and the homeownership rate suggests that more people will prefer renting to owning a home. A new housing initiative may be part of the September jobs plan.	**Fixed Income, Tax-exempt – pg 14** Municipal yields lagged the Treasury rally, but still fell sharply. The technical backdrop becomes less favorable over the next few months as there will be less money rolling off just as supply is expected to rise. If tax revenues slip again as the economy slows, several states have automatic triggers for additional spending cuts to kick in.
International – pg 10 The focus in Europe turned to the sovereign debt of Italy and Spain. As their yields rose the ECB purchased bonds to help push rates back down; probably not a viable long-term solution. Growth remains another big concern for the euro region. Elsewhere, Japan lowered their growth outlook for fiscal year 2012.	**Alternatives – pg 15** The was a large $9.5B sale of commercial real estate from the Anglo Irish Bank loan portfolio. The winning bidders were reportedly seeking to capture value as real estate values continue to recover. Gold's price rose to nearly $1,900/oz as euro debt concerns rose, but retreated near month-end.

Monthly Performance Review

Equity Indices	11-Aug	3-Mos.	6-Mos.	YTD	12-Mos.	3-Yrs	5-Yrs
S&P 500 Index	(5.43)	(8.90)	(7.23)	(1.77)	18.50	0.54	0.78
Dow Jones Industrials Index	(3.96)	(6.01)	(3.73)	2.14	19.03	3.18	3.17
NASDAQ Composite	(6.42)	(9.02)	(7.29)	(2.77)	22.02	2.90	3.39
Russell 1000 Index	(5.76)	(9.41)	(7.45)	(1.93)	19.06	0.84	1.11
Russell 1000 Growth Index	(5.28)	(7.57)	(5.40)	0.18	23.96	3.08	3.75
Russell 1000 Value Index	(6.24)	(11.21)	(9.45)	(3.99)	14.37	(1.45)	(1.62)
Russell MidCap	(6.88)	(12.13)	(8.49)	(3.00)	21.29	2.95	2.99
Russell MidCap Growth Index	(6.82)	(11.74)	(7.38)	(1.71)	25.61	3.80	4.28
Russell MidCap Value Index	(6.93)	(12.50)	(9.52)	(4.18)	17.51	2.04	1.36
Russell 2000 Index	(8.70)	(14.03)	(11.17)	(6.54)	22.19	0.83	1.53
Russell 2000 Growth Index	(8.57)	(14.03)	(9.39)	(4.60)	27.54	2.14	3.59
Russell 2000 Value Index	(8.83)	(14.02)	(12.99)	(8.52)	16.86	(0.57)	(0.62)
MSCI EAFE Index	(9.03)	(11.60)	(11.12)	(6.02)	9.99	(2.96)	(1.48)
MSCI Emerging Mkts Index	(8.94)	(10.73)	(5.11)	(8.55)	9.07	5.05	8.40
	-	-	-	-	-	-	-
Alternative Indices	11-Aug	3-Mos.	6-Mos.	YTD	12-Mos.	3-Yrs	5-Yrs
DJ UBS Commodity Index	1.00	(1.25)	(1.00)	1.31	25.83	(4.50)	0.84
DJ Wilshire REIT Index	(5.64)	(7.21)	(1.69)	6.45	20.05	1.72	(0.42)

Source: Dow Jones; Barclays Capital; Russell Investments; Bloomberg

Note: Highlighted items represent either the best or worst performance for the period within the asset class

Monthly Performance Review

Fixed Income Indices	11-Aug	3-Mos.	6-Mos.	YTD	12-Mos.	3-Yrs	5-Yrs
Barclays Aggregate Index	1.46	2.77	5.49	5.88	4.62	7.23	6.56
Barclays G/C Interm. Index	1.07	2.34	4.66	5.04	4.01	6.32	6.11
Barclays US Treasury Index	2.78	4.30	7.08	6.98	4.17	6.12	6.60
Barclays High Yield Index	(4.00)	(3.84)	(1.55)	1.94	8.39	11.95	8.10
Barclays 1-10-yr Muni Index	1.44	2.39	4.73	5.54	3.07	5.55	5.24

Month-end Market Levels

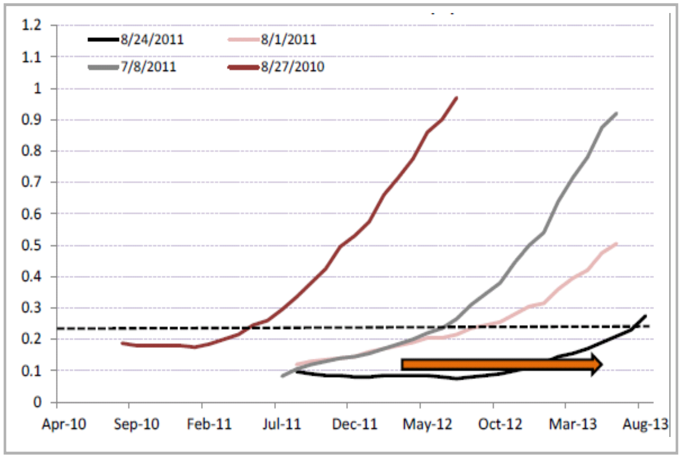
Bond Yields	11-Aug	11-Jul	11-Jun	10-Dec	10-Aug
Fed Funds Rate	0.13	0.13	0.13	0.13	0.13
3-month T-bill yields	0.01	0.09	0.01	0.12	0.13
2-yr Treasury yields	0.20	0.36	0.46	0.59	0.47
5-yr Treasury yields	0.96	1.36	1.76	2.00	1.33
10-yr Treasury yields	2.22	2.80	3.16	3.29	2.47
5-yr Agency	1.24	1.65	2.02	2.20	1.60
5-yr A-rated ML Corp Master	3.18	3.01	3.38	3.63	3.06
5-yr AAA Muni yields	0.89	1.16	1.28	1.63	1.06
Other Markets	11-Aug	11-Jul	11-Jun	10-Dec	10-Aug
WTI Crude Oil ($/bbl)	88.81	95.70	95.42	91.38	71.92
Gold (US$/troy oz)	1831.70	1631.20	1502.80	1421.40	1,250.30
US$/Euro	1.44	1.44	1.45	1.34	1.28

Source: Dow Jones; Barclays Capital; Russell Investments; Bloomberg

Spotlight: Bernanke to Obama and Congress – "I Need Your Help"

The federal government has two major levers to help influence the economy: monetary and fiscal policy. On the monetary side, the Federal Reserve has a dual mission: to minimize inflation while maximizing employment. On the fiscal side the mission, it seems, is – get (re)elected. As demonstrated over the last several years, the Fed has many tools at their disposal and have been willing to use them when deemed appropriate. What Ben Bernanke said in his recent speech at the global economic conference in Jackson Hole, WY was, essentially, "The Fed is doing its part, but we need help on the fiscal side." The Fed's latest move, clarifying that they will not raise interest rates for at least two years, was an important message to the markets. Bond investors understood and pushed any expectation of a hike in the fed funds rate out beyond August 2013, as shown in the adjacent chart. While the Fed has additional, albeit unconventional, tools left, they're increasingly ineffective with rates already so low and lack of fiscal policy coordination.

Fed Funds Futures



Source: Bloomberg

Bernanke called for a long-term fiscal plan to reduce the budget deficit but also more stimulus in the short run. Some have compared his plea to that of St. Augustine's: "Oh Master, make me chaste and celibate, but not yet!" President Obama has promised a jobs plan in early September that will likely include an extension of the 2% payroll tax cut as well as extending unemployment benefits, but the markets are hoping for more. While neither of these extensions are new policies, at least they won't add to the fiscal drag if allowed to lapse. Some are also speculating that new housing initiatives will be announced that could help clear excess inventory and/or streamline the mortgage refinancing process. Yet, many are skeptical of the effectiveness of another housing measure after so many others have met with limited success. While hope springs eternal, recent confidence surveys suggest people are running low on patience for things to improve.

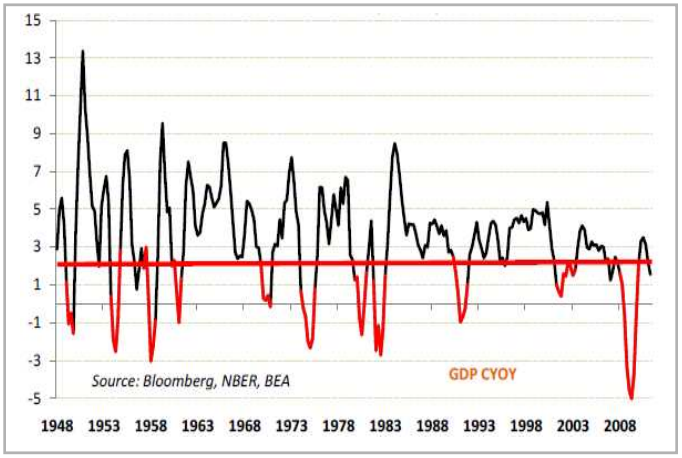
Certainly the president has a strong urgency to get something done prior to the onset of the full 2012 election cycle, particularly since all policies take time to bear fruit. The risk, of course, is whatever policies he outlines will be viewed as either ineffective by the markets, or unacceptable to Congressional Republicans, or both, leaving the burden of boosting growth solely on the shoulders of the Fed. If that's all there is, then the recent market volatility may persist.

Monthly Economic Update & Market Review

U.S. Economic Growth:

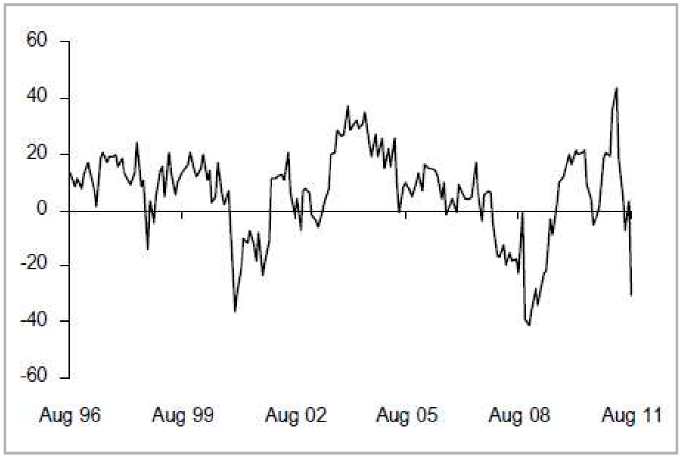
- Second quarter growth was revised lower to 1.0% from the 1.3% initial estimate on weaker exports and less inventory accumulation. With this revision, the six-month pace of growth for the first half of 2011 slowed to 0.7% and just 1.5% YoY. While some have labeled this pace "stall speed," too slow to meaningfully reduce the unemployment rate, the risk of recession rises at such a sluggish pace. Since 1948, each time that YoY real growth slowed to less than 2.0% the economy was either already in recession, or fell into recession within a year (Chart 1).
- The manufacturing sector had been the growth engine, but it too has slowed over the last three months. Several regional manufacturing surveys have reflected this, but none as dramatically as the Philadelphia Fed survey. The general activity index fell to a recession-like -30.7 from 3.2 in July (Chart 2). The ISM Purchasing Managers Index for Manufacturing for August slipped 0.3, but still held above 50, at 50.6.
- Another growing concern has been weak consumer and business confidence surveys. The NFIB Small Business Optimism survey was at 89.9 in July, down from 94.5 in February. Also, the Univ. of Michigan Consumer Confidence survey showed a decline to 55.7 in August from a recent peak of 74.3 in May. This reading is only slightly above the November 2008 low of 55.3 in the midst of the financial crisis.

Chart 1: U.S. Real GDP (YoY%)



Source: Bloomberg

Chart 2: Philadelphia Fed Survey Activity Index



Source: Bloomberg

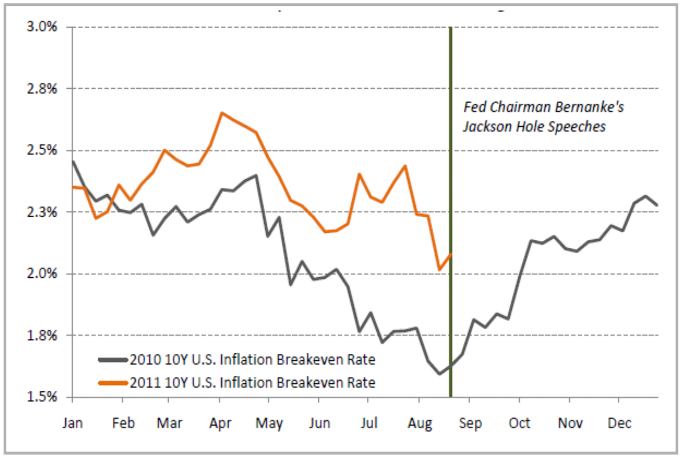
Inflation:

- The Consumer Price Index (CPI) was unchanged in July and has held at an elevated 3.6% YoY level for the past three months. MoM prices are on the rise, but they're no worse than the months rolling off from last year. One positive sign regarding inflation that is not fully reflected in recent data is the decline in energy prices. Oil has fallen as the economy has slowed.
- While headline inflation is stable, core inflation rates continue to inch higher. Excluding food and energy prices, the core-CPI is now up 1.8% YoY, above the 1.6% YoY pace in June and double the 0.9% YoY pace of August 2010 (Chart 3).
- While none of these consumer inflation readings are worrisome to investors, particularly with the pace of economic growth slowing, they are high enough to impact monetary policy. Last year, when the Fed embarked on a second round of quantitative easing (QE2), market expectations for inflation were significantly lower than they are currently (Chart 4), making the hurdle that much higher for the Fed to overcome if considering additional QE steps.
- Gold, the precious metal many view as a hedge against higher inflation swung wildly in August. After reaching a record \$1,891/oz. on the 22nd, prices fell 7% to \$1,757/oz. before stabilizing at month end.

Chart 3: Core-Consumer Price Index (YoY %)

Source: Bloomberg

Chart 4: 10-Yr Breakeven Inflation Rates



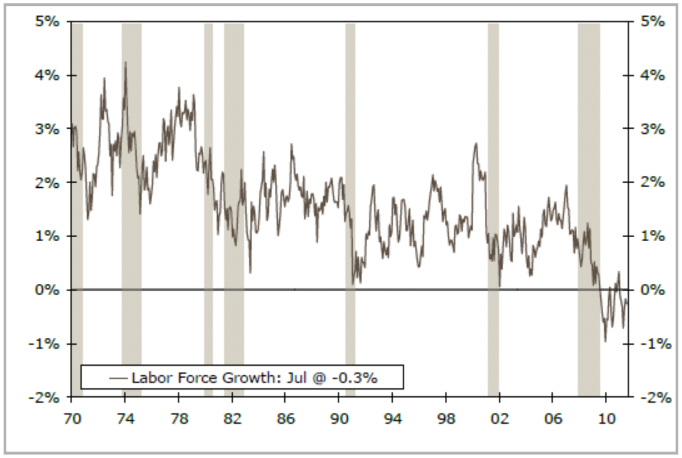
Source: Bloomberg

Monthly Economic Update & Market Review

Employment:

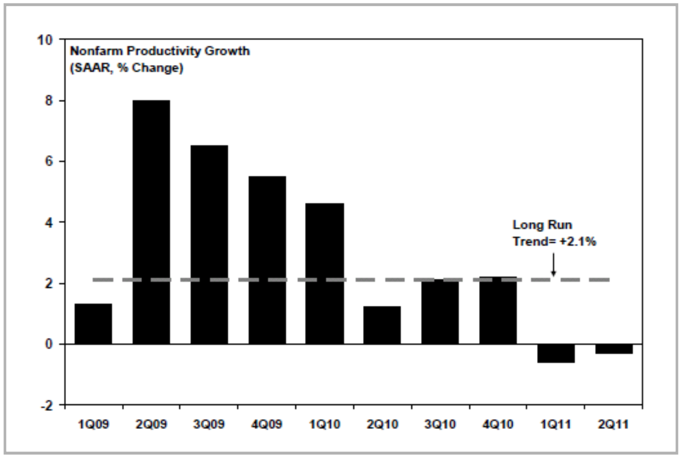
- The employment report for July was better than in June, but still disappointing. 154,000 private sector jobs were added, up from 57,000 the prior month, but the government sector showed continued contraction, losing 37,000 jobs, similar to the 39,000 loss in June.
- The unemployment rate inched down to 9.1% from 9.2%, but primarily because of a decline in the labor force. Unlike past recoveries and economic expansions where workers reenter the labor force as the economy improves, in this cycle people continue to drop out of the labor force (Chart 5). In fact, the labor force participation rate, which is the percentage of the population that is employed, either part-time or full-time, fell from 64.1% in June to 63.9% in July, the lowest level since 1984.
- One modestly encouraging sign on the employment front is that even as the economy has slowed, the level of first time jobless claims has held relatively steady, between 400,000 and 420,000 per week since early July. This will be an important economic indicator to watch for tracking any change in the pace of growth.
- Productivity normally surges in a slowdown, as output remains the same but with fewer workers. It then slows in a recovery as productivity gains are harder to come by. That pattern has held recently and suggests firms may soon need to hire more workers if they want to continue to grow (Chart 6).

Chart 5: Labor Force Growth (YoY %)



Source: Wells Fargo Securities Research

Chart 6: Nonfarm Productivity Growth (% Change)

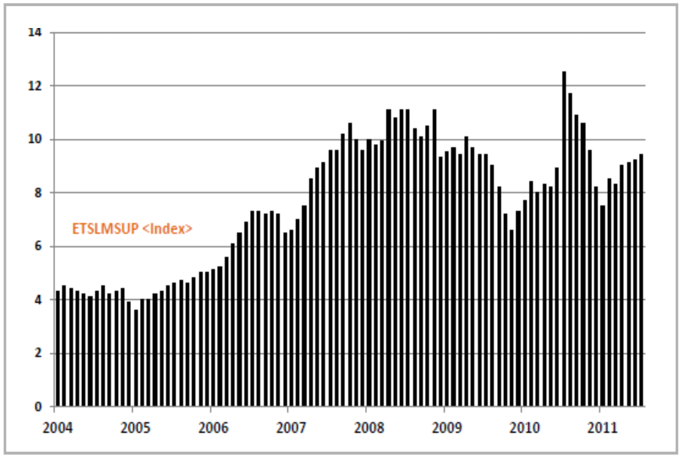


Source: Bloomberg

Housing:

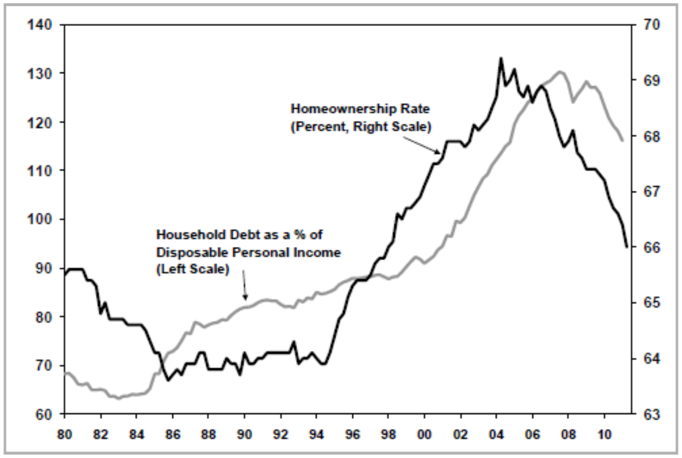
- The pace of existing home sales fell 3.5% in July to 4.67 million units. New home sales also fell, -0.7% to a 298,000 annual pace. The summer months are typically a stronger period for sales as families move before the new school year, but that wasn't the case this year. As a result, home inventories have risen. At the current sales pace, there are 9.4 months of existing home supply, up from 9.2 months in June (Chart 7).
- The S&P/Case-Shiller report for July showed another modest price decline, -0.1% MoM on a seasonally adjusted basis. The YoY decline was -4.5%.
- There has been a strong correlation historically between the level of household debt and the homeownership rate (Chart 8). As people have deleveraged their personal balance sheet, the level of homeownership has also come down. Household debt as a percentage of personal income is still well above long-term averages and looks poised to decline further. The same can be said for the percentage of the population looking to own a home rather than rent.
- Some are speculating that President Obama will soon unveil one or more new housing initiatives to help boost sales and economic growth. While homeowners may be hopeful, there is also great skepticism after so many other similar attempts have failed. The fact that any major initiatives require Congressional approval just prior to an election cycle only add to the challenge.

Chart 7: Existing Homes – Months' Supply



Source: Bloomberg

Chart 8: Homeownership Rate and Household Debt

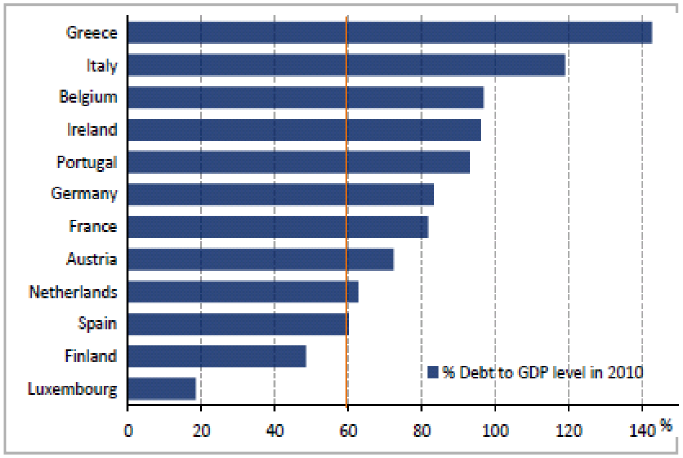


Source: Bloomberg

International Developments:

- While most of the focus this year has been on Greece, Ireland, and Portugal, concerns over both Italy and Spain escalated last month. Italy has the third largest bond market in the world, behind only the U.S. and Japan. It also has the second highest debt/GDP level in Europe behind only Greece (Chart 9). Concern over European bank exposure to sovereign debt, put them under renewed pressure again last month.
- Fears over Italian and Spanish debt drove their sovereign yields to unsustainable levels, prompting the European Central Bank (ECB) to provide support. For a time, the 10-year yields for each nation were above 6%, and nearly 400 bps over German yield levels (Chart 10). The ECB was successful in pushing yields back down, but it's uncertain how much they are willing to commit to sustain the lower rates, particularly with Germany publicly critical of the ECB intervention.
- In addition to debt concerns, Europe also suffers from too little growth. Growth among the 17 nation euro region in the 2Q slipped to just 0.2%, from 0.8% in 1Q.
- Japan lowered it's growth forecast for fiscal year 2012, which began in April, to 0.5% from 1.5% after the economy contracted at a 1.3% annual rate in the 2Q. To help boost growth, Japan released $100B in exchange reserves to aid exports and help weaken the yen.
- China widened the trading band for the yuan relative to the U.S. dollar by 0.23% to help temper inflation.

Chart 9: Percentage Debt to GDP Level by Country



Source: Bloomberg

Chart 10: Italian – German Credit Spread (bps)

Source: Bloomberg

Monthly Economic Update & Market Review

Large Cap Equities:

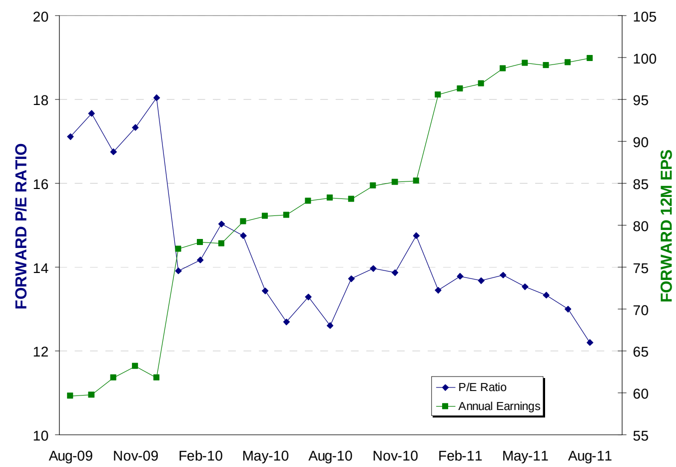
- The S&P retreated 5.4% in August to extend the monthly losing streak to four consecutive months. Stocks have now lost 10% from the 2011 high on April 29 (Chart 11). The market was especially volatile following the U.S. debt downgrade on Aug. 5th as stocks swung by at least 4.6% per day in the four trading days (2 up, 2 down) following the change.
- The recent volatility has led to an erosion of confidence for both individuals and businesses (or vice-versa?). Factors contributing to declining confidence include: Euro contagion fears, debt downgrade, slowing domestic and foreign growth, stagnant housing and high unemployment. Lack of investor confidence is demonstrated by steadily declining P/E ratios as investors are less willing to pay a certain multiple for a dollar of earnings, this despite rising earnings (Chart 12). Lack of business confidence is demonstrated by a stubbornly high unemployment rate and high cash levels on corporate balance sheets.
- Directionally, the equity markets will look to the coming earnings reporting season, starting in mid-October, for guidance. It's uncertain how much recent weakness has impacted sales and earnings, particularly for large companies with overseas exposure. Any significant earnings pre-announcements in September could be a harbinger of equity performance during the fourth quarter.

Chart 11: S&P 500 Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	10.7%	-5.3%	1.2%	26.6%
Consumer Staples	11.3%	0.6%	6.9%	20.1%
Energy	12.4%	-9.7%	1.2%	34.3%
Financials	14.2%	-9.6%	-15.5%	0.1%
Health Care	11.8%	-2.1%	7.3%	21.2%
Industrials	10.5%	-6.5%	-6.0%	17.1%
Info Technology	18.6%	-6.0%	-2.5%	20.5%
Materials	3.6%	-6.7%	-6.5%	19.9%
Telecom Services	3.1%	-1.3%	-0.4%	15.6%
Utilities	3.7%	2.3%	10.6%	15.0%
Total		-5.4%	-1.8%	18.5%

Source: Bloomberg, Wilshire Atlas

Chart 12: Declining P/E's in Spite of Rising Earnings



Source: Bloomberg, M&I Quantitative Solutions Group

Monthly Economic Update & Market Review

Mid- and Small-Cap Equities:

- Small stocks posted their third worst August ever, declining 8.7% as volatility spiked on increased fears of a recession both here and in Europe. The Russell 2000 index is also off almost 16% since the April 30 market peak. Secondary stocks bore the brunt of investors moving to de-risk their portfolios as evidenced by the significant outflows in small-cap stock funds. Small-caps now trail large-caps by almost 5% YTD.
- Energy was the worst performing sector in August with a drop of almost 17% (Chart 13). Defense was the best offense this past month as Utilities actually rose 2.2% and Consumer Staples were off "only" 3.2%. These are also the only two sectors YTD to post positive returns while Technology and the more economically sensitive Consumer Discretionary and Materials have led on the downside.
- Small growth marginally held up better than small value during the month, but the Russell 2000 Growth index leads by almost 4% YTD with a decline of 4.6% versus 8.5% for small value.
- The Russell Mid-cap Index fell right between large and small-caps with a decline of 6.9% in August and 3.0% YTD (Chart 14). Mid-cap sector performance reveals a similar pattern to small-caps but with more upside performance from the defensive sectors.

Chart 13: Russell 2000 Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	13.2%	-10.0%	-8.3%	23.4%
Consumer Staples	3.6%	-3.2%	4.4%	23.9%
Energy	7.0%	-16.9%	-5.0%	41.1%
Financials	21.8%	-6.9%	-8.0%	11.9%
Health Care	12.5%	-8.9%	-0.6%	25.1%
Industrials	15.5%	-8.6%	-9.6%	22.6%
Info Technology	16.8%	-9.3%	-10.0%	23.4%
Materials	4.9%	-9.0%	-7.6%	27.1%
Telecom Services	1.0%	-8.2%	-1.0%	23.9%
Utilities	3.7%	2.2%	9.6%	21.9%
Total	100.0%	-8.7%	-6.5%	22.2%

Source: Bloomberg, Wilshire Atlas

Chart 14: Russell Mid Cap Sector Performance

Sector	Weight	1 Mo	YTD	1 Year
Consumer Discretionary	15.6%	-7.0%	2.2%	34.6%
Consumer Staples	6.4%	-1.9%	13.4%	29.2%
Energy	8.4%	-11.5%	-1.3%	37.2%
Financials	18.9%	-8.2%	-8.2%	9.6%
Health Care	10.1%	-6.7%	3.1%	26.8%
Industrials	12.1%	-7.4%	-10.0%	18.4%
Info Technology	13.2%	-7.1%	-11.1%	13.8%
Materials	6.9%	-7.8%	-3.1%	21.8%
Telecom Services	1.3%	-5.0%	-10.4%	10.0%
Utilities	7.0%	1.1%	11.3%	19.8%
Total	100.0%	-6.9%	-3.0%	21.3%

Source: Bloomberg, Wilshire Atlas

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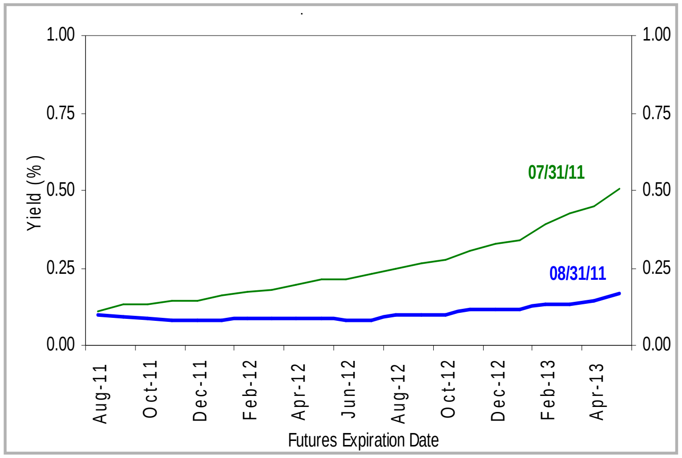
Fixed Income Market – Taxable:

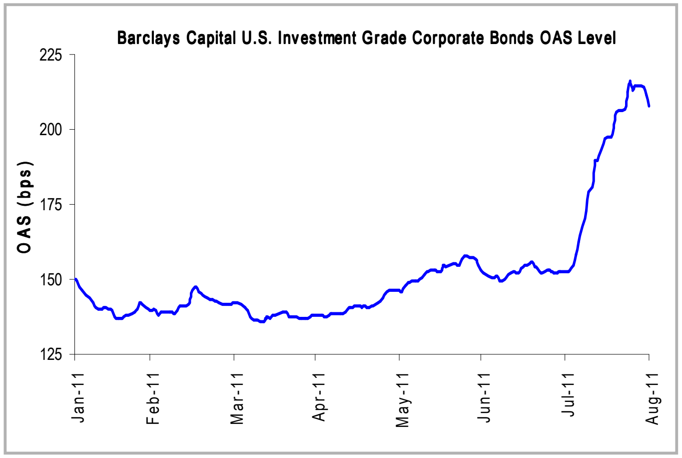
- In spite of S&P downgrading the credit rating of the U.S. government to AA+ from AAA, weak economic data and a Fed pledge to stay on hold for at least two years were the stronger forces helping to push Treasury yields lower in August. Two year yields fell 17 bps while 10- and 30-year rates fell more than 50 bps.
- The fed funds futures market reacted by lowering expectations for the fed funds rate to below 25 bps across the forward curve (Chart 15). By clarifying their intention, the Fed essentially authorized investors to extend, if not leverage, their fixed income investments to capture the roll of a steep curve.
- Credit spreads widened relative to Treasuries on weaker economic data and Fed announcement to hold rates steady for the next two years. Rather than falling with Treasury yields, both investment grade (Chart 16) and high yield rates rose, leading to significant underperformance for the month. Memories of the financial crisis are still fresh in investors minds and any hint of a recession leads to selling, particularly in the high yield sector.
- The mortgage sector also lagged Treasuries, but to a lesser extent. Rumors swirled about various housing proposals that President Obama might consider to boost growth, including lowering the rate on all government guaranteed mortgages. The complexities and inefficiencies of such a move make it very unlikely.

Chart 15: Fed Funds Futures Yields



Source: Bloomberg

Chart 16: Investment Grade Corporate Spreads (OAS, bps)

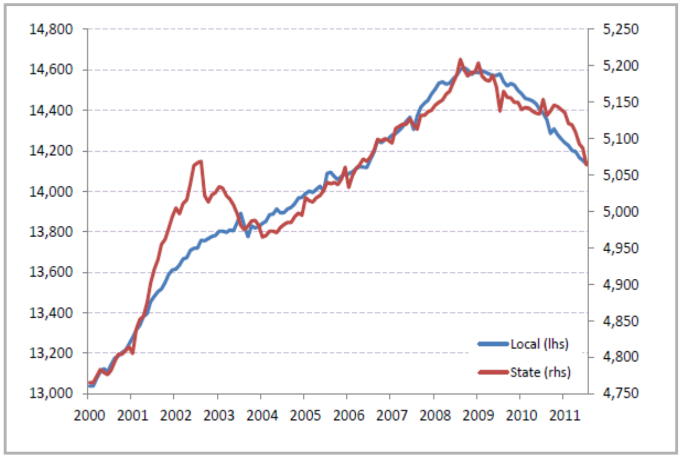


Source: Barclays Research

Fixed Income Market – Tax-exempt:

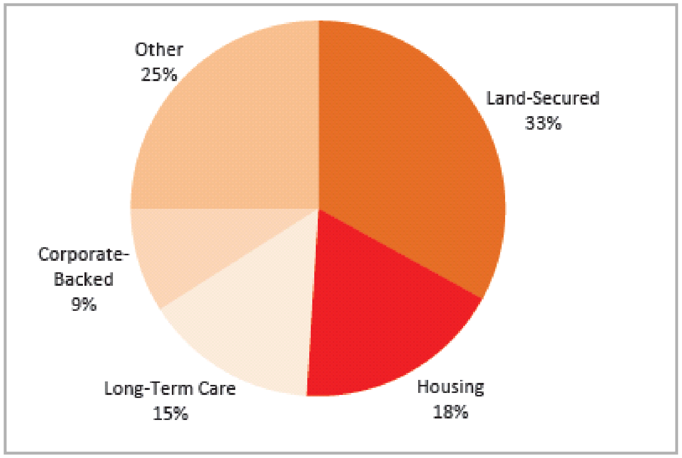
- The downgrade by S&P of the U.S. government also affected an estimated 11,500 municipal issues that were either directly or closely tied to Treasury and Agency bonds. There was little impact on market prices, however, as tax-exempt yields followed the trend of the Treasury market. Two year yields fell 10 bps while 10-year and 30-year yields fell at least 40 bps in August.
- Over the last three months, roughly $45B per month of tax-exempt debt has matured or been called away, providing solid reinvestment demand for light new supply. The roll-off in the September – November period, however, falls to just $18B/mo. on average at the same time that supply pressures will likely build into year end. The result may be a cheapening of municipals relative to taxable debt.
- State and local government employment is in a secular decline (Chart 17) which may become even more acute if tax revenues slow again, as looks possible. In July, tax revenues in California were 10% below budget. If this persists, automatic spending cuts may be triggered, including more layoffs, in California and elsewhere.
- Municipal defaults in 2011 remain well below last year's levels. There were 392 monetary defaults between 2007 – 2010, but 75% of these fell into just four sectors of the market (Chart 18). Defaults among general obligation and essential service revenue bonds, the more traditional municipal issuers, would be a small portion of the "other" category and remain very rare.

Chart 17: State and Local Government Employment (000's)



Source: Bloomberg

Chart 18: Historical Defaults by Sector (2007 – 2010)



Source: Bloomberg

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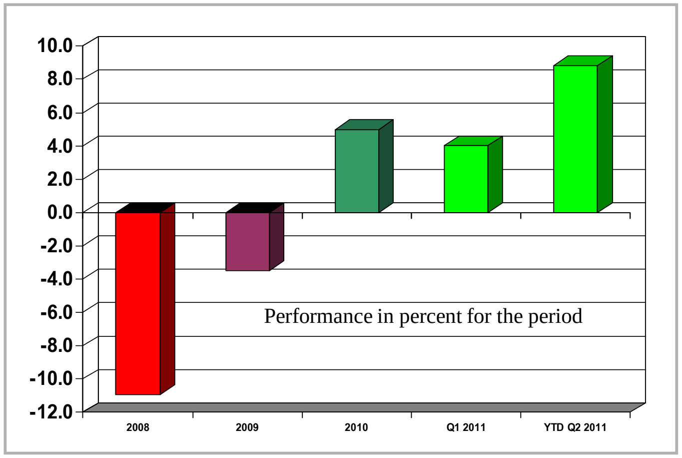
Alternative Markets:

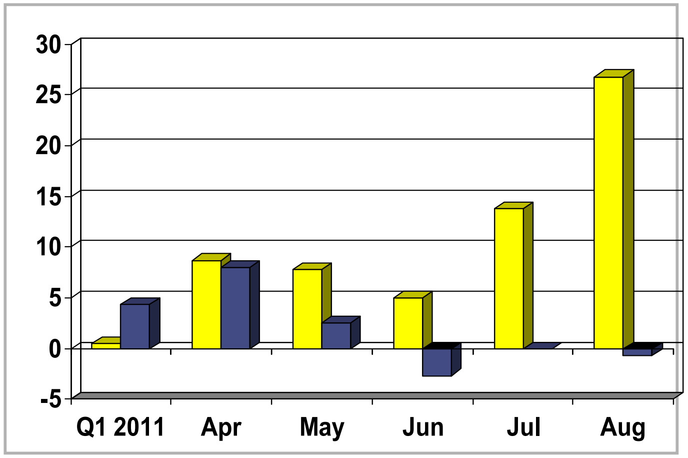
- The Wall St. Journal reported on the sale of $9.5B of U.S. commercial real estate from the Anglo Irish Bank loan portfolio. The winning bidders were two large banks and a private equity firm. There were, reportedly, three alternative investment themes prompting their interest: (1) the opportunity to acquire cheap assets from a troubled European bank, (2) the value of distressed debt when real estate values are in recovery, and (3) the demand from investors for alternatives to low yielding fixed income investments. Contrary to market sentiment, open-end core equity real estate funds have outperformed the broader market through 2Q (Chart 19).
- Gold's performance has disconnected from broader commodity baskets this year (Chart 20). When Europe seemed incapable of addressing its euro currency related debt crisis, gold prices flirted with $1,900/oz., only to retreat as analysts cautioned that prices were over extended, and that higher margin requirements would dampen speculation.
- Long/short hedge fund managers struggled when the European financial regulators instituted a ban on short sales of banks, and then again when Warren Buffet surprised market speculators with his $5B investment in Bank of America, whose stock price had been battered by litigation exposure related to Countrywide mortgage underwriting.

Chart 19: Diversified Core Equity Real Estate (% Return)



Source: NFI – ODCE

Chart 20: YTD performance of GLD vs. Commodity Index



Source: UBS Research

For further information, please visit our websites at…

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