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“Fixed income had a great January as credit tightened and interest rates remained stable. But we still seek resolution to many substantial concerns.”

Watching From Our Foxhole

Credit zoomed tighter in January; it was “risk on” pretty much all the way. Most marketplace wags view the European Central Bank’s Long Term Refinancing Operation (LTRO) as a game changer. This policy tool provided three-year loans to European banks, resulting in massive rallies in many European sovereign debts as those banks reloaded on the carry trade, holding country debt. It was temporary relief, at least. Risk was bought, and the can was firmly kicked down the road. Add in the good-enough U.S. economic data and largely empty dealer inventory shelves, and credit risk had a great month.

Then the FOMC weighed in late in the month, expressing worry about the economy and deflationary forces. It extended its low rate guidance and published its projection for the first rate hike. The central bank’s main concerns are probably 1) the global economic situation dragging down the U.S., 2) the impact of fiscal headwinds and 3) the consumer’s inability to command income gains. This affirmed that interest rates will stay at recent levels, if not through 2014 — the Fed’s own projection — then at least through the immediate future.

When we have some of our longer chats with colleagues and clients to discuss the “macro” view and the market movements, the same couple things tend to come up. Now, they do so with even less debate; it’s more of a collective acknowledgement of the same issues that have been around a while.

First, Europe remains the big monster under the bed, and the sovereign/banking stress there is hard to handicap. The impact of whatever happens is very significant, and few see anything good coming from it. The LTRO was helpful, producing some good

data around sovereign and bank funding rates. But risks remain around the Greek bailout, and Portugal appears to have asked for the next place in line. The real question we want to know is if the U.S. can decouple from Europe.

Second, there are numerous positive domestic economic and market data points. U.S. manufacturing is doing better, and housing looks to have gained its floor. Certainly there has been improvement in unemployment claims, maybe the best high-frequency economic indicator we have. But any upticks in data get quickly overshadowed by the long slog we yet have to improve bank balance sheets, adjust government spending to more sustainable trajectories, sort out the foreclosure mess and alter expectations of consumer spending. Income growth trailed consumption growth in the fourth quarter, leading to the conclusion that holiday shopping was supported by a decline in savings. These issues raise big questions as to whether the economy can maintain the growth pace of late-2011.

Investors peek out of the foxholes (well the bond guys do anyway — we’re always worried), going through these issues and pondering what to do until there is more clarity. We see the citizenry saving more (maybe willing to spend only at holidays and then probably just on technology gadgets), desirous of income investment vehicles, inclined to rent rather than own, and equipped with amazingly partisan politics. They’ve come through the last few years chastened and are likely unwilling to ever again get themselves in the kind of situation that is still under repair. This is not the type of behavior that would result in a revamped borrowing and spending spree! Given that, it’ll be a slow grind to an improved economy. ■

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