



# Fort Washington Investment Advisors, Inc.

A member of Western & Southern Financial Group

JULY 2010



**Nicholas P. Sargen, PhD**  
Chief Investment Officer

## 2010 Mid-Year Update: Level Setting Expectations

- Growth Scare
- Deflation Watch
- Fiscal Drag
- Investment Implications

---

*Past performance is not indicative of future results. This publication contains the current opinions of Fort Washington Investment Advisors, Inc. Such opinions are subject to change without notice. This publication has been distributed for informational purposes only and should not be considered as investment advice or a recommendation of any particular security, strategy, or investment product. Fort Washington, or its affiliates, may from time to time provide advice with respect to acquire, hold, or sell a position on the securities mentioned herein. Information and statistics contained herein have been obtained from sources believed to be reliable but are not guaranteed to be accurate or complete. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of Fort Washington Investment Advisors, Inc.*

©2010 Fort Washington Investment Advisors, Inc.



## 2010 Mid-Year Update: Level Setting Expectations

Midway into 2010, are you confused about the state of the U.S. and global economy and unsure what to do with your investment portfolio? If so, don't fret — you are in good company. A recent Bloomberg report (July 8) states that hedge fund managers, Wall Street's best compensated and supposedly smartest investors, are "dazed and confused" after having suffered their worst second-quarter performance in a decade:

"Hedge-fund managers, who oversee \$1.67 trillion in assets, are reluctant to put money to work as they are buffeted by a wide range of often conflicting political and economic forces, from fiscal policy in Europe and the U.S., to what regulations will be imposed in the financial-services and energy industries, to the growth prospects in China."

If the best and the brightest are struggling, what should mere mortals do? Our answer is that now is a good time to level set expectations. As recently as mid-April, the prevailing view in the markets was that the global economy was on track for a self-sustaining recovery and interest rates were headed higher. However, since then long-term treasury yields have fallen by a full percentage point, as worries about global recovery have surfaced and inflation expectations have plummeted. World equity markets, in turn, have experienced large sell-offs, following steady gains for 13 months (Figure 1.).

Figure 1: A Tale of Three Markets (Returns in percent)

	Rally	Selloff	Correction
Equities	3/10/09 - 4/30/10	9/1/08 - 3/9/09	May - June
S&P 500	79.6%	-46.4%	-12.8%
EAFE (\$)	76.6%	-49.4%	-12.4%
EM (\$)	115.5%	-48.7%	-9.5%
Bonds			
Treasuries	-0.5%	6.4%	3.6%
Corporate	24.1%	-5.5%	1.6%
High Yield	70.6%	-26.0%	-2.1%

Returns for equity indices are based on total return, including dividend and price changes  
Performance data quoted represents past performance which is no guarantee of future results  
Source: Bloomberg

One of the main issues we consider in setting investment strategy is whether the turn-around in markets is based on new information about the U.S. and global economy, or whether it mainly reflects fear and emotion. *Our assessment is that recent data point to a moderate slowdown in the global economy, but the evidence is not compelling to conclude that recovery is in jeopardy or that deflation is imminent.*

How the global economy fares in the next 6-12 months, moreover, will be influenced by the way policymakers respond. Our views on this issue have shifted. Previously, we believed the Federal Reserve and European Central Bank would begin to tighten monetary policies later this year, but we now think they are on hold well into 2011. At the same time, fiscal policies are becoming a drag on global growth, and the movement afoot towards increased government regulation is adding to business uncertainty.

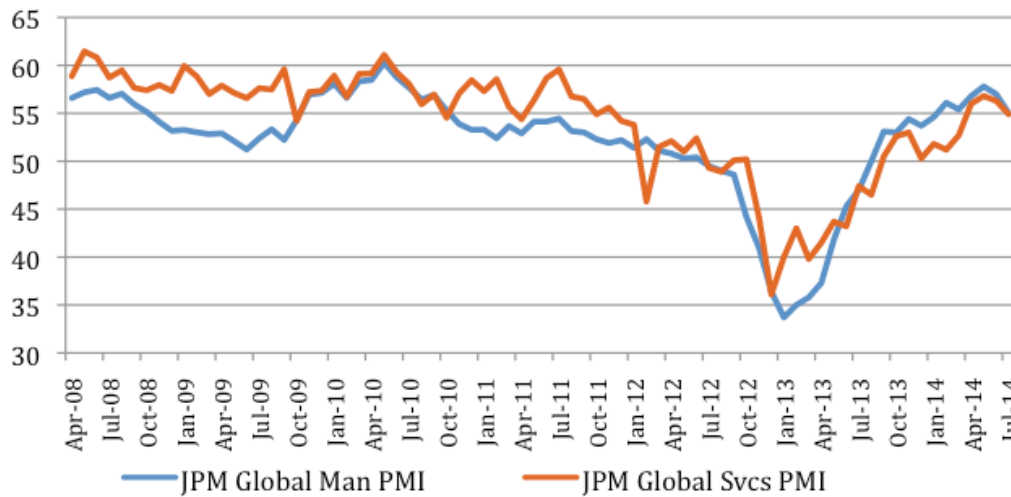
Given the prospect of continued moderate growth, low inflation and policy uncertainty, this is not the time to make bold bets on the direction of markets. That said, we do not find cash or treasuries attractive, and we are continuing to over-weight corporate bonds in fixed income portfolios. On the equity side, valuations are becoming attractive, but are not yet compelling to add to overall exposure. Accordingly, we are keeping balanced portfolios near their long-term strategic allocations.

## Growth Score

Until recently, most investors, including ourselves, viewed the global economy as headed for a self-sustaining recovery, in which policymakers could begin to reduce the massive stimulus that was injected in the past two years. Since late-April, however, several developments have challenged this view including the following:

- The debt crisis in Greece became a much bigger problem within the euro-zone that could spill-over to the rest of the world.
- Global manufacturing, which propelled recovery in 2009 and early 2010, slowed in May-June, along with activity in service sectors (Figure 2).
- The fastest growing region – China/Emerging Asia – showed signs of cooling off from double-digit growth.
- In the United States, job growth as measured by private non-farm payrolls slowed to a monthly average of less than 60,000 workers in May-June.

Figure 2: Global Manufacturing and Services Moderating



Source: JPMorgan Economics

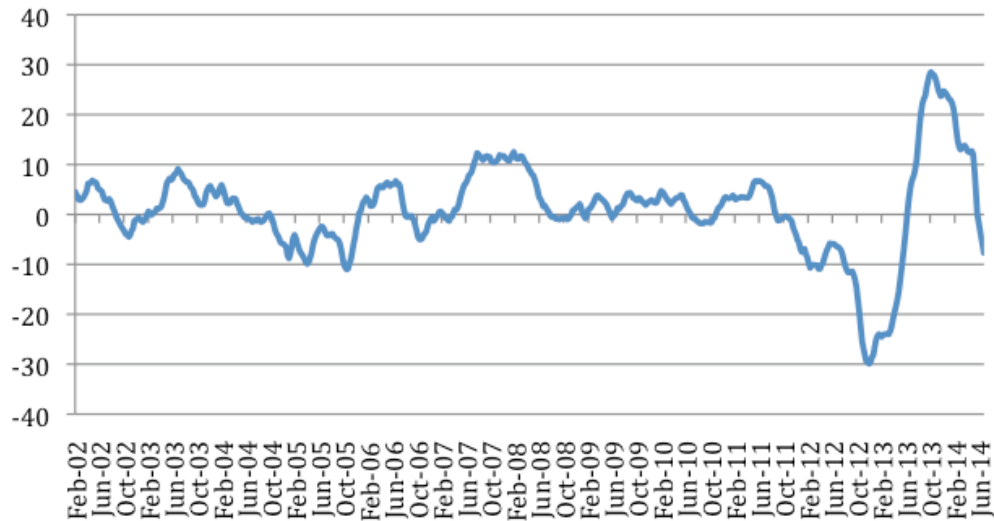
In the wake of these developments, forecasters have been trimming their projections of economic growth for the United States and other parts of the world. The consensus for U.S. real GDP growth in the next 6-12 months appears to be shifting to less than 3% from 3%-3.5%. China is expected to slow to 8%- 9% from 11% earlier this year, while Europe is projected to soften to 1% from 1.5%-2%.

By and large, these revisions appear reasonable to us. However, the recent market moves reflect deeper concerns on the part of investors. Indeed, many fear that global recovery is stalling and vulnerable to shocks.

One indicator that has become a favorite of market bears is the Economic Cycle Research Institute’s (ECRI) Weekly Leading Index. It is currently the only leading indicator to suggest a “double dip”, as its growth rate has turned negative (Figure 3). Nonetheless, while the index has a strong track record, it is very sensitive to financial indicators. Moreover, the ECRI itself is not calling for a recession.



Figure 3. The Bears' Favorite Indicator



Source: Economic Cycle Research Institute, Bloomberg

We prefer to look at two other market signals – the shape of the treasury yield curve and spreads for corporate bonds (investment grade and high yield) versus treasuries. Prior to the 2008-09 downturn, both of these indicators correctly signaled recession, as the yield curve was inverted and credit spreads widened significantly as defaults surged. Today, by comparison, the yield curve is steeply sloped, and the recent widening in credit spread spreads mainly reflects the decline in treasury yields, rather than rising corporate yields.

Our bottom line is that U.S. economic recovery is likely to remain sub-par into 2011. Job growth averaged 100,000 workers per month in the first half of this year, which is sufficient to keep the unemployment rate from rising. However, to be confident that the economy is transitioning to self-sustaining recovery, this figure needs to double in the next 12 months.

### Deflation Watch

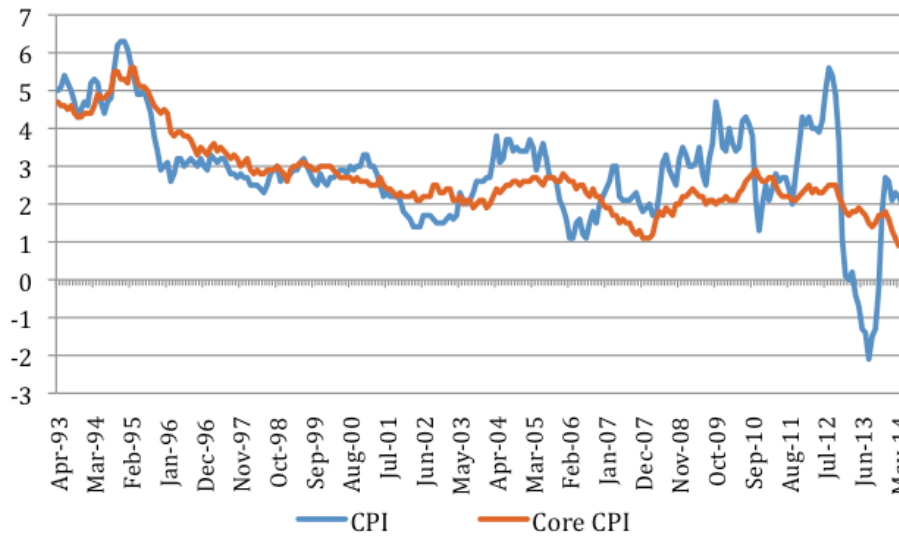
While the sell-off in global equities is greater than we anticipated, a bigger surprise has been the steep decline in U.S. treasury yields. At the start of this year, we expected treasury yields to rise amid signs of economic recovery and record issuance of U.S. government debt. Our call appeared on track through early April, when yields on the 10-year and 30-year maturities rose to 4.0% and 4.85%, respectively. Since then, however, yields have plummeted by a full percentage point.

Initially, treasuries (and the U.S. dollar) were beneficiaries of the crisis in the euro-zone, which spawned a flight to quality. But that is not the sole factor at play. There has also been a significant reduction of inflation expectations. The break-even inflation calculation for treasuries versus TIPs, for example, has fallen to 1.7% recently from nearly 2.5% in early April.

Some reduction in inflation expectations is understandable, considering that core inflation (which excludes volatile food and energy components) in the United States has fallen to about 1% recently, while commodity prices have softened (Figure 4.). Previously, market participants expected inflation to rise gradually as the economy gained traction, but this has been undercut by the softening. Indeed, we now expect both core and headline inflation to remain subdued into 2011.



Figure 4. U.S. Inflation is Trending Lower



Source: Bureau of Labor Statistics, Bloomberg

With core inflation readings in the U.S., Europe and Japan all at 1% or less now, the issue currently being debated among market commentators and policymakers is whether deflation – or falling prices – poses a serious threat. Central banks, in particular, need to be cognizant of this risk, because history indicates it is very difficult to overcome deflationary forces, as evinced by Japan’s experience in the past two decades. Fortunately, there is no indication of deflationary pressures elsewhere in the Asia/Pacific area. In fact, China and several other central banks in Asia have begun to tighten monetary policies as strong economic growth has boosted inflationary pressures.

At the same time, we are monitoring conditions in Europe closely in the wake of the euro-zone crisis. The European Central Bank currently is providing added liquidity to lessen counterparty risk in the inter-bank market. But it also has been taking offsetting actions to neutralize the impact on the money supply. Ultimately, the ECB may have to allow the money supply to expand if European growth is to resume.

In the United States, the Federal Reserve under Chairman Bernanke has a good grasp of what needs to be done to counter deflation. In 2008-09, when the banking system was imperiled following Lehman’s collapse, the Fed took unprecedented action including quantitative easing to bolster the banking system. With the financial system in much stronger shape today, the risk of balance sheet destruction and money supply contraction has diminished considerably. Indeed, Chairman Bernanke has sought to reassure the public that the Fed stands ready to take necessary action to stabilize the system. Our call is that U.S. inflation will stay low into 2011, and the Fed will refrain from tightening monetary policy well into next year.

### Fiscal Drag

While economic conditions are not as dire as market bears perceive, we do not see a catalyst that will cause the global economy to reaccelerate. When global demand collapsed in late 2008, governments around the world responded with massive stimulus programs to counter the weakness in private sector demand. These programs along with coordinated monetary policy easing and support for the financial systems are generally credited with reigniting growth in 2009.

More recently, however, the debt crisis in Greece and other southern European countries such as Portugal and Spain has forced governments to take active measures to shrink their budget deficits. Other countries such as the UK, German, France, Italy and Japan have followed suit by announcing fiscal consolidation measures. At the recent G-20 meeting, U.S. officials urged countries to coordinate their fiscal exit strategies to assure that global recovery is not derailed. Unfortunately, countries such as Germany, Japan and China that are running large external surpluses show little interest in stimulating domestic demand.



Meanwhile, the impact of fiscal stimulus is lessening in the United States. According to JPMorgan's economists, more than one half of the \$787 billion stimulus package signed into law in early 2009 has now been disbursed. This still leaves over \$300 billion to be spent, but the *incremental* effect is beginning to wane. Accordingly, fiscal policy is expected to act as a drag on economic growth over the next year and a half – on the order of 1 ¼% according to Morgan's economists. These estimates, moreover, do not take into account the added drag that could be coming from repeal of the Bush tax cuts at the beginning of 2011 or the effects that legislation in the healthcare and financial sectors will have on the economy.

This leaves us with the following quandary: What will it take to get U.S. corporations confident to hire workers and to grow their businesses? On one hand, we are encouraged by the ability U.S. companies have demonstrated in restoring profitability and bolstering their balance sheets during dire circumstances. Yet, corporations lack conviction, because they are uncertain about the economy and tax/regulatory environment. Indeed, former Fed Chairman Alan Greenspan has pointed out that U.S. companies have accumulated excess cash balances in the vicinity of one trillion dollars, and that commercial banks are sitting on another one trillion dollars of excess reserves. With the federal government and U.S. households facing limited resources, it seems clear that policy should be directed at creating an environment where corporations will be encouraged to deploy this cash. However, this may not happen until after the Congressional elections.

### Investment Implications

Given the economic and policy uncertainties, we do not feel compelled to change our investment strategy at this time. A year ago, when asset prices were cheap and economic policies began to take hold, we over-weighted corporate bonds and added to equities out of cash. Today, by comparison, markets are priced for moderate growth and low inflation, which is the most likely outcome. Although job growth in the next 6-12 months may not be sufficient to wean the economy off massive policy stimulus, we are reluctant to hold treasuries or excess cash at current low yields. Our preference is to hold corporate bonds and short-dated instruments to earn incremental income. Finally, amid the recent gyrations, the stock market appears fairly priced, and we are keeping stock:bond allocations in balanced portfolios near their strategic allocations.

