Setting the Stage for 2013

Prepared: January 2, 2013

Introduction

As we prepare for the start of the new year, it appears the U.S. is still dealing with a number of risks to its economic health. The New Year’s Day agreement by policymakers in Washington on a tax plan for 2013 and beyond was an initial step in the right direction and generally consistent with what we had anticipated, but it left a number of issues related to the fiscal cliff unresolved. Thankfully, the new law appears to address most of the imminent risk concerns to our economy for the short term. However, we anticipate that fiscal cliff pressures will build again, perhaps as early as February. We continue to closely monitor the situation and health of the broader economy and will soon release a paper which outlines the fiscal cliff issues in more detail. Beyond concerns about the fiscal cliff, other areas of particular focus include:

• Persistently low interest rates and questions about the point at which rates will reverse course and begin to rise
• Inflation and whether the environment may be susceptible to more significant and sustained price increases
• An economy that seems to be stuck in low gear and hard pressed to generate the level of growth that has been typical of most economic recoveries
• Federal Reserve policy going forward and the ultimate impact of what many consider as extreme measures to prop up a struggling economy

This paper examines each of these issues and offers our analysis of what may lie ahead.

Interest rates — where we stand today

Interest rates in the U.S. remain at what would historically be considered abnormally low levels. This can be attributed to three primary causes, only the first of which we classify as “normal.” Each are described below.

Reason #1: Slow Growth

Lower interest rates are a predictable outcome in a slow growth economic environment like the one we’ve experienced in recent years. This reflects a couple of factors:

• Generally, when economic activity is lower, prices for goods and services remain fairly stable, keeping inflation in check. Interest rates often track closely to inflation rates.
• Slower economic activity may lead to less demand for money in the form of loans to fund investments and business growth. This lower demand likely leads to excess liquidity on bank balance sheets, which can potentially drive down interest rates as banks invest their excess reserves in bonds, rather than loans.

Reason #2: Flight to Safety

Investors from across the globe tend to view the U.S. financial system as one of the most secure and liquid in the world. Many investors perceive bonds issued by the U.S. government and other entities (large corporations, municipalities, etc.) as a “safe haven” in times of economic distress. We have experienced a global “flight to safety” since the financial crisis of 2008. The emergence of Europe’s debt crisis has contributed to this trend. With global demand for U.S. bonds on the rise, the interest rates on Treasury securities are bid lower.

There is historical precedent for such a flight to safety scenario. The only other period where ten-year U.S. Treasury notes hovered near 2% was in the aftermath of World War II in the 1940s. At that time, the U.S. stood alone in the world — the only economy not in shambles as a result of the war. Much
of the available capital in the world found its way into U.S. Treasury bonds, driving interest rates to low levels. The magnitude of today’s interest rate drop is extremely rare and an indication of the extent of global concerns.

**Reason #3: Federal Reserve Policy**

Federal Reserve (Fed) monetary policy plays a large role in keeping interest rates low. When the financial crisis erupted in 2008, the Fed added more than $1 trillion of liquidity. This helped to free up liquidity markets that had frozen. The Fed also cut interest rates in an effort to limit the impact of an inevitable recession. Since that time, the Fed has rained an additional $1 trillion into the U.S. economy through quantitative easing strategies. The goal is specifically to help keep interest rates unusually low to try to boost the recovery. The current posture of the Fed is to maintain a near zero interest rate policy until the unemployment rate drops to 6.5% or less, or inflation (as measured by Personal Consumption Expenditures) rises above 2.5%. As we near one of these “trigger” points, the Fed will evaluate current monetary policy.

**When will interest rates rise?**

Are we likely to see interest rates rise dramatically in the near term? We believe the short answer is no. Each of the factors listed above are likely to persist into the foreseeable future.

The U.S. economy, currently growing at a rate of close to only 2% in 2012, may only grow modestly faster in 2013, perhaps at a 2.5% rate. This remains below normal for a typical recovery, and certainly not fast enough to create upward pressure on interest rates.

The flight to safety environment may also be in place for some time, particularly given the challenges that continue in Europe. Our view is that the recent, relatively calmer conditions in the European Union (EU) are not likely to last. We anticipate that pressures will build again within the EU in 2013.

In addition, the Federal Reserve appears determined to maintain its current interest rate posture for some time — likely another two years, in our view.

Does this mean we should be unconcerned about interest rate risks? Not at all. An important point to remember (as indicated in the accompanying chart) is that it is not normal for rates to be this low. Very unusual circumstances continue to be at work. There is little room for interest rates to fall from this level. However, we are confident that interest rates will eventually rise, possibly at a rapid clip.

**Interest Rates Remain Near Historical Lows**

(10-year U.S. Treasury)

From a wealth management perspective, we are very focused on what could prove to be potential triggering events for higher rates. The primary risk to investors is that when rates rise, the value of bond portfolios can fall precipitously. This may represent a significant amount of latent risk, particularly for those investments in Treasury bonds. At some point in time, rates will rise in a sustainable way. Therefore, we advise caution for holdings in Treasury securities as the downside risk is apparent and the bond market will eventually revert to a more historically normal interest rate environment.

The key question, of course, is the timing of such an upward move in rates. We believe a significant, sustained increase may not occur for another two to three years. The Fed’s interest rate stance is a signal that economic growth is likely to remain below the desired 3% plus level (annual growth rate) during this time. Other issues that are contributing to the low rate environment, such as Europe’s debt woes, are not likely to be resolved quickly. As such, this places a premium on a disciplined wealth management...
process and underscores the importance of asset allocation and overall investment selection.

**Inflation expectations**

Inflation is a reflection of supply and demand. The price of an individual good or service tends to rise or fall based on demand for that good or service relative to its supply. Inflation occurs when demand significantly exceeds supply. The rate of inflation in the U.S. economy reflects aggregate supply and demand factors for goods and services across the broad economy. Some of those inputs have more impact on the reported inflation rate than others. Typically, rapid economic growth is required to trigger more demand for goods and services — an environment that could lead to periods of higher inflation.

In today’s economy, the lack of strong demand for more workers (reflected in the stubbornly high unemployment rate) creates little pressure to drive wages higher. Similarly, although the overall housing market appears to be stabilizing, we remain in the early innings of a housing recovery, so demand for housing is muted, resulting in little upward pressure on home prices. Labor costs and housing represent two of the largest components of the broad measure of general inflation in the U.S., the Consumer Price Index (CPI). Low demand and excess supply for these two major components means that official inflation measures reported each month remain modest. Housing costs, which tend to be fixed for most people, represent 41% of the index. The impact of relatively flat labor costs isn’t specifically singled out in the CPI, but is incorporated into costs of most elements of the index.

We have seen more significant increases in the prices of food and fuel since the financial crisis of 2008. This is driven in large part by increased demand from developing countries, including giant emerging markets like China and India. In some cases, higher prices for specific commodities may be triggered by concerns about supply — for example, when drought potentially limits food production, or conflict in the Middle East impacts energy production.

Prices for food and energy have mostly been trending higher in recent months. This has been very visible to consumers because prices are part of their day-to-day spending. Yet food and energy represent less than 20% of all the components factored into the calculation of CPI, so the impact on the official inflation rate has been limited.

**Inflation remains in a historically healthy range**

Inflation risk from stimulus

A significant amount of stimulus has occurred since the financial crisis, including the 2009 fiscal stimulus plan from the federal government and trillions of dollars in monetary stimulus from the Federal Reserve. Such efforts can affect inflation in two ways:

1. It can be like adding fuel to the economic engine. This tends to cause the engine to run faster. If stimulus leads to a faster growing economy, this can affect the supply-demand balance in different areas of the economy. The demand for labor may outpace supply, which occurs when unemployment levels are low. The supply of commercial spaces may not keep up with demand from booming businesses, resulting in low vacancy rates. The supply of industrial materials could be stretched as companies produce more goods, etc. This type of environment can create price inflation.

2. Under certain circumstances, greater stimulus can flood the engine with more fuel than the engine can actually use. The greatest risk from the impact of monetary stimulus, where the supply of extra dollars stimulates rapid growth,
may be a surge in the supply of dollars that could deflate the value of those dollars if supply exceeds demand. In this scenario, listed prices will rise, but not because the value of the goods has risen. Rather, it’s because the value of the currency has fallen, requiring more dollars to buy the same amount of goods. In effect, monetary deflation has the same impact as inflation.

Is there a risk that the trillions of dollars in monetary stimulus by the Fed in recent years could lead to a debasement of our currency? We believe there is little chance of this occurring. Surprisingly, even though the supply of dollars has increased significantly, demand for dollars has also risen dramatically during the same period as indicated by the heavy influx of foreign investment into U.S. Treasury bonds. Supply and demand for the dollar appears to be in approximate balance. The U.S. economy itself could not generate this much demand. What has occurred is a flight to safety among global investors who have poured significant sums into U.S. Treasury bonds. This reflects continued uneasiness about the stability of the global economy, with Europe being an area of significant concern. The dollar is still the reserve currency of the world, which helps prop up demand. In the current environment, the tremendous supply of dollars created by the Fed is not at risk of outstripping continued global demand.

While current conditions may not be ripe for higher levels of inflation, the risk of future inflation remains. The environment could change depending on economic developments and other factors. In the near term, particularly given the Fed’s plan to maintain low interest rates for some time, it seems unlikely that the inflationary environment will alter dramatically, making it unlikely that a significant immediate impact will be felt by investors. Still, investors may benefit by including commodity positions as a small portion of a well-diversified portfolio to protect against the potential effect of higher inflation.

**The strength of the economy**

Three years after the end of the “Great Recession,” the U.S. economy remains weak. This can be attributed to a variety of issues, many of which are inter-related. Several factors stand out as having a significant bearing on the state of our economy and need to be understood to properly set expectations going forward.

The largest factor constraining a more robust economic rebound may well be the amount of debt that consumers and businesses have carried. For at least a decade prior to the financial crisis of 2008, we witnessed an historic borrowing spree. For example, in the mid-1990s, households held total debt that on average equaled about 90% of their disposable income. By the peak of 2007, the debt ratio reached more than 135% of disposable income. Businesses, on average, were also operating with high debt levels compared to historic norms.

To a certain extent, the financial crisis was triggered by a debt crisis in which debt levels reached a tipping point. Since the financial crisis, we’ve experienced broad based deleveraging by both businesses and consumers, and added leverage by the federal government. The emphasis today by businesses, consumers and government policymakers alike appears to be on either paying off or writing off debts. An economy in such a deleveraging mode typically experiences slower growth, leaving less capital in the system for current consumption or to invest for future growth.
The buildup of debt experienced prior to the financial crisis was not limited to the U.S. The same thing occurred in many other developed economies. Europe is a prime example. Most of these countries are experiencing a similar deleveraging cycle.

What can be done to alleviate the impact of deleveraging? Unfortunately, there are no quick fixes — beyond a vast defaulting of debt, or debt forgiveness, which likely leads to a sharp, but short, recession. The federal government has been trying to stimulate more growth than what the economy could deliver on its own during a deleveraging cycle. However, the reality is that we have to gradually climb out of the deep debt hole that we have dug.

**Expect a slow recovery to continue**

How long will it take to overcome our debt binge? If history is any guide, it should take about as long to wind down the debt as it took to accumulate it in the first place. If we assume that we borrowed heavily for ten years, we probably need to plan on a similar length of time to deleverage. Although we’ve been in recovery for more than three years, it may take at least twice that amount of time to overcome the effects of deleveraging.

Economic activity. With several key trading partners experiencing slower growth themselves, our trading volume will be reduced, further tempering growth prospects in the U.S.

The reality is that the U.S. and all other countries are operating in an increasingly interconnected market for goods, materials and services. The global economy presents both opportunities and challenges to the U.S. There is significant potential for U.S. companies that produce goods and services to generate sales overseas. U.S. companies have proven to be very competitive on a global scale and also benefit from being in a strong financial position. Conversely, the emergence of the labor market on a global scale has created greater competition that is a challenge to our workforce. U.S. workers are now compared to global competitors on the basis of overall cost, education, skill and experience. In an increasingly globalized economy, outcomes for U.S. workers can vary significantly.

Those who are highly educated with strong technical skills appear to be thriving even if their industries face stiff global competition. Those at the opposite end of the spectrum, with less education and limited technical skills, are dealing with very difficult employment prospects. This is especially true for industries where competition is fierce. The shift toward a global labor market has had a huge impact on the U.S. economy. As a result, our unemployment rate is likely to remain stubbornly high for several years, especially for low-skill workers with limited education. Wage growth for this segment of the market is also likely to be limited.

The changing nature of the labor market presents yet another obstacle to a more robust economic recovery. With approximately 70% of the U.S. economy driven by consumer activity, persistently high unemployment and low wage growth for blue collar workers only dampens expectations. Nevertheless, it is notable that even with the modest pace of economic recovery that we’ve already experienced, stock markets have rallied significantly over that period and continue to trend in a positive direction. Investors will likely view even a modest rate of growth over the next year favorably.
The U.S. Economy Has Recovered to All-Time Highs, But Employment Has Not

Source: FactSet, Strategas Research Partners.

It is obvious from our summary that significant macro factors are the primary drivers of the state of our frustratingly slow economic recovery. Given that reality, it is not likely that government action can have a notable impact in the short term. However, governments can initiate policies that would create a more positive growth environment over time. We will wait and see whether policymakers can accomplish this as a new Presidential term begins and a new Congress is seated in Washington. It seems plausible that investors could react favorably to news that major progress was made in achieving long-term solutions. A positive market response could result from significant tax reform and firm plans to better control future government spending.

The Federal Reserve forecast

The essential function of the Federal Reserve is to keep the U.S. economy growing at a healthy rate, finding a balance between “not too slow” and “not too rapid.” Specifically, the Fed is charged with managing inflation and employment to achieve this healthy rate of economic growth. The Fed’s primary mechanism to manage the economy is through the buying and selling of government debt.

During the summer of 2008, before the financial crisis exploded in the fall, the Fed held approximately $700 billion in assets on its balance sheet. During the fall of 2008 and into 2009, the Fed invoked its first phase of quantitative easing. The Fed increased its balance sheet to $1.9 trillion essentially by injecting liquidity into the economy and purchasing assets, such as government bonds.

Most economic and financial experts applauded the Fed’s actions at the time as critical to helping the U.S. economy avoid a collapse into a depression. Skeptics argued that market forces, rather than Fed action, should drive the economy’s recovery and that the Fed’s actions just delayed further pain and perhaps set the stage for a future crisis. Fed proponents agree that its powers over the money supply are not to be used casually. The generally accepted view in most quarters is that modern central bank actions have helped stabilize economies and limited the number of crises, as well as the pain associated with crisis situations.

After its initial efforts, the Fed continued to expand the money supply through successive quantitative easing efforts or other strategies even though the crisis situation has passed and an economic recovery has been underway since 2009. Each successive Fed monetary easing has raised new concerns that the Fed’s continued aggressive effort at boosting liquidity carries with it some inherent dangers.

The Federal Reserve’s Increasing Balance Sheet

Total Assets of the Federal Reserve
Indicating Its Increased Stimulus Activity

Source: Federal Reserve; data period August 2007 - October 2012.

So why is the Fed still adding liquidity to the markets even though the economy is recovering? Fed chairman Ben Bernanke has indicated that it is because the U.S. economy would be hard pressed to sustain a recovery during an extended period of deleveraging. With American consumers and businesses reducing their debt loads, it is difficult for the economy to achieve normal rates of growth. The Fed is trying to offset the impact of the massive deleveraging cycle with its monetary easing policies.
Rather than worry about the risk of inflation, the Fed has been more concerned with the potential for deflation (declining prices), so it is willing to keep its foot on the gas to drive inflation modestly higher.

The Fed’s policies also reflect its responsiveness to one of its mandates, which is to promote employment. The unemployment rate has remained stubbornly high. The expectation is that additional monetary stimulus should help heat up economic activity and ultimately boost demand for workers. What is out of the ordinary is that the Fed has sought to achieve its other mandate, keeping inflation in a normal range, by trying to create an environment that increases inflation up to a “normal” level.

**Balancing the risks**

What risks are created if the Fed continues on its current “easy money” path? We understand the Fed’s view that it needs to maintain an active monetary stimulus approach to counteract cyclical conditions that are threatening the current economic recovery. However, we are also concerned about pockets of inflated assets that may expand dangerously while the Fed applies its stimulus medicine. After all, excessive monetary stimulus prior to the financial crisis may have contributed to the real estate and credit bubbles that were largely responsible for the crisis.

Today, risks are primarily associated with the potential of creating an oversupply of dollars, thereby reducing the value of the currency. Global demand for U.S.-based bonds has nullified this risk to date. At some point, demand for U.S. dollars will decline and the Fed will need to unwind current monetary stimulus actions. This could have a negative impact on the economy. Failure to reduce the amount of stimulus could lead to disastrous inflation for the country.

The Fed has indicated it will maintain its easing stance at least until employment improves (as evidenced by the unemployment rate approaching 6.5%), or inflation creeps into the system and grows by 2.5% or more (as evidenced by Personal Consumption Expenditures inflation, excluding food and energy).

The challenge is that monetary policy involves an imperfect set of tools and an endless array of unpredictable variables that can intrude on the best-laid plans. With that in mind, we remain confident that the Fed will continue to be a leader among all the world’s central banks in setting a standard for monetary policy. Yet, we will remain vigilant on behalf of our clients, preparing for the impact of potential changes in the environment that could alter the inflation landscape. A sudden upturn in the rate of inflation could also result in higher interest rates, leading to a deterioration of bond values. The impact of higher rates on stocks may depend on other economic circumstances at the time.

**Investment guidance**

As you assess your portfolio, here are steps to consider given our economic outlook:

- **Remain true to sound financial planning principles and continue to implement your investment strategy consistent with your long-term objectives and risk tolerance.** Remember that regardless of short-term market or economic developments, there are opportunities to position your portfolio effectively to keep your long-term investment objectives on track.

- **Consider equity positions that offer attractive value in the current environment.** Equity markets are likely to remain volatile, but may offer value opportunities as some issues discussed in this paper are rectified.

- **For growth-oriented portfolios, assess the full range of opportunities that may be available by including positions in international equities and alternative investments to more effectively diversify your asset mix.**

- **In fixed income portfolios, limit the amount of exposure to Treasury securities.** Instead, look to corporate debt securities that provide potential for better long-term value.

- **As a hedge against the risk of higher inflation, holding a position in commodities may be beneficial.** Commodities (such as energy and agricultural products) tend to increase in value during periods of higher inflation.

As always, we recommend you work with your advisor to evaluate your financial needs and discuss appropriate portfolio actions.

Important disclosures provided on page 8.
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