J.J. BURNS & COMPANY, LLC

2nd Quarter Newsletter, July 2012

AS THE WORLD CHURNS

Many of you may remember the soap opera "As The World Turns." What's interesting about soap operas is that week by week very little happens. The story has not changed much in the world of finance either. Familiar patterns tend to repeat themselves in soap operas, and ironically, this is the case in the world of global economics. The stock market indices for 2012 hit their highs for the year in April, but have since declined to only being up a few percentage points. Bond markets, specifically US Treasuries, continue to see increases in price as their yields drop. Six months of 2012 are behind us and the global world of finance continues to "churn."

For more than three years running we have seen bond yields decline into the summer months. This was preceded by yields rising in the first part of the year. Yields have continued to move lower and have continually decreased more than the preceding year. (Bond note: as yields decline, bond prices (values) rise.) Why is this occurring? The primary driver of yields moving lower specifically on Treasury bonds is the dysfunction among countries and leaders in Europe. As an example, on May 28th, the Spanish Prime Minister was stating publicly about how Spain was in no need of outside help and that "there will be no Spanish banking rescue." Today, in return for funds, Spain will relinquish some of its sovereignty regarding bank inspections, and as a result, supervision will now be undertaken by regulators who will inspect their financials and propose that the banks begin the painful process of shedding bad assets which remain on the financials of many banks in Spain. What we are seeing in Spain, Greece, and other "Club Med" countries (even globally) is a lack of accountability. For all the excitement of the "rescue plans" happening it says little about the lack of credibility of the prior bank stress tests that supposedly were to prevent events like this. This can all be confusing to the lay person, even for some in finance. This "rescue" recapitalizes the banks and thus the market (inclusive of the US) stage a temporary rally as, for the meantime, the "worst" case was avoided. Our leaders are not addressing (in the case of the both the Club Med countries and the United States) that we still face intense recession pressures and structural economic deficiencies. Fighting debt with more debt is a "band-aid" solution. It does save banks, however in Spain it raised their debt/GDP (gross domestic product) ratio by 10 percentage points!

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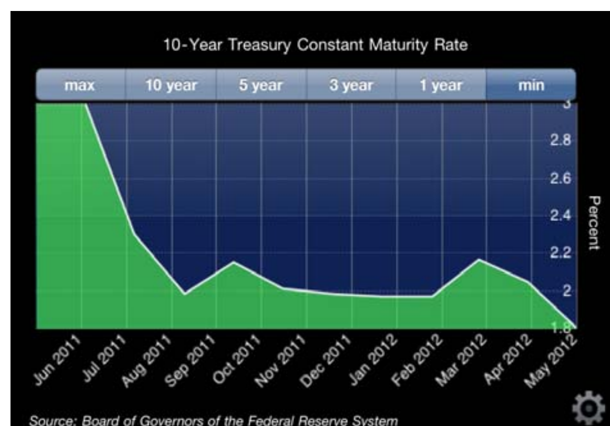
The decision for government officials in Spain to finally admit they need external funding is significant. Spain could not raise these funds by issuing bonds at any reasonable interest rate. The problems which mount are not much different than that of an individual who has over extended their personal finances, by credit card, mortgage, and other personal debts. If the income/revenue cannot meet the debt payments then additional sources of financing are explored. If there are no other sources of funding available then this person is likely to file bankruptcy, wipe the slate clean, and start over. The debtors (credit card, banks/mortgage companies) are defaulted on and receive little or no payment. How will Spain, Greece and other European countries cover their mountain of debt and deficit financing at a time when the foreign investment community have withdrawn? What's even more perplexing is given Italy's own intense economic problems and debts (Italy is the 3rd largest debt country) that it will be funding over 20% of the rescue plan for the Spanish banks.

Why Yields May Go Lower

Unlike some European countries, America may borrow money at a lower yield than at any other time in the history of our nation. Great Britain and Germany have raised money at historically low yields as well. The global economic slowdown has created a demand from institutions and savers alike to preserve their principal. These investors are not concerned about the "return on their capital" but the "return of their capital." The Economist Bond Brief provided me with some interesting data as follows: Investors have invested nearly $1 trillion into bond funds since the start of 2009. Negative interest rates don't deter investors. The yield on short term Treasuries have actually gone negative on occasion without affecting demand. Having liquidity and safety are some of the reasons why this occurs. To Spaniards or Greek citizens, where the former could lose 40% of the value of their currency if they end up converting back to the drachma, a 0% return looks like a great deal. Safety of principal is more important than yield. The other part of this story is government central banks, like the Federal Reserve, are deliberately cutting interest rates to near zero levels. The Federal Reserve continues with lower yielding programs such as QE (quantitative easing) and most recently Operation Twist. The strategy behind renewing Operation Twist is to utilize the exchange of short term bonds for longer term bonds. This plan will help to artificially lower long term interest rates as well as short term rates. The Federal Reserve would like to keep bond yields lower through 2014. The hope of the Federal Reserve, along with the rest of the industrialized world, is that low rates will stimulate worldwide growth.



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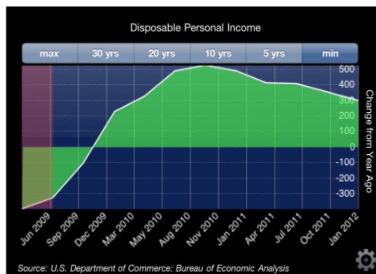
Fiscal Cliff, Fiscal Policy? What Fiscal Policy?

Investors are also concerned about the lack of fiscal policy direction. By the end of 2012 tax rates on income and capital gains are scheduled to rise substantially. This potential increase in tax rates has hindered job creation and business expansion. Business owners are reluctant to hire, given the uncertain tax and regulatory environment. Retail sales, manufacturing and jobs market data are telltale signs of this slowdown.



The lack of action and disagreement in Congress is arguably at an all-time high. As such, the budget debate at the federal level creates uncertainty and economic weakness. At the government and state levels there is likely to be a significant decline in spending. This would only add fuel to an already burning fire. The deleveraging scenario that households, state and local governments continue to contend with, may keep economic activity from accelerating to any large degree.

Bonds For The Long Haul?

Our friends at BCA Research noted the following: Since September 1981, the real returns for holders of 30-year Treasury bonds have been an annualized 8.8%. That makes the past few decades one of the two great bond bull markets in history; the other was between mid-1920 and the end of 1940, when annualized return were 9.2%. The issue with "some" bonds, and specifically US Treasuries, is that bond yields have fallen so far that most of the benefits of future capital gains by bond yields falling further is limited. This does not pertain to high yield bonds which are paying upwards of 7%-8% interest. Many corporate balance sheets in this arena are healthy and can provide significant yield pickup over US Treasuries. JJBCo. continues to have a significant portfolio weighting in high yield corporate debt because history suggests investing in Treasuries with such low yields may not be our best option. Over the 35 year period starting in 1945, investors who purchased 2% Treasury bonds earned a negative real rate of return. We believe rates may continue to decline or remain the same, given that since the crisis of 2008, commercial banks are now required to hold larger liquidity cushions in the form of government bonds. These regulations are also imposed on insurance companies. The byproduct of the financial crisis is that most of the owners of Treasury bonds are unconcerned about interest rate outcomes since they are required to own them. Conventional wisdom about the relationship to price and yield in the bond market may have been turned upside down by the new regulatory requirements. America may now have the capacity to finance large deficits, which could wind up being a distinct advantage to ultimately help the economy grow itself out of the debt hangover.

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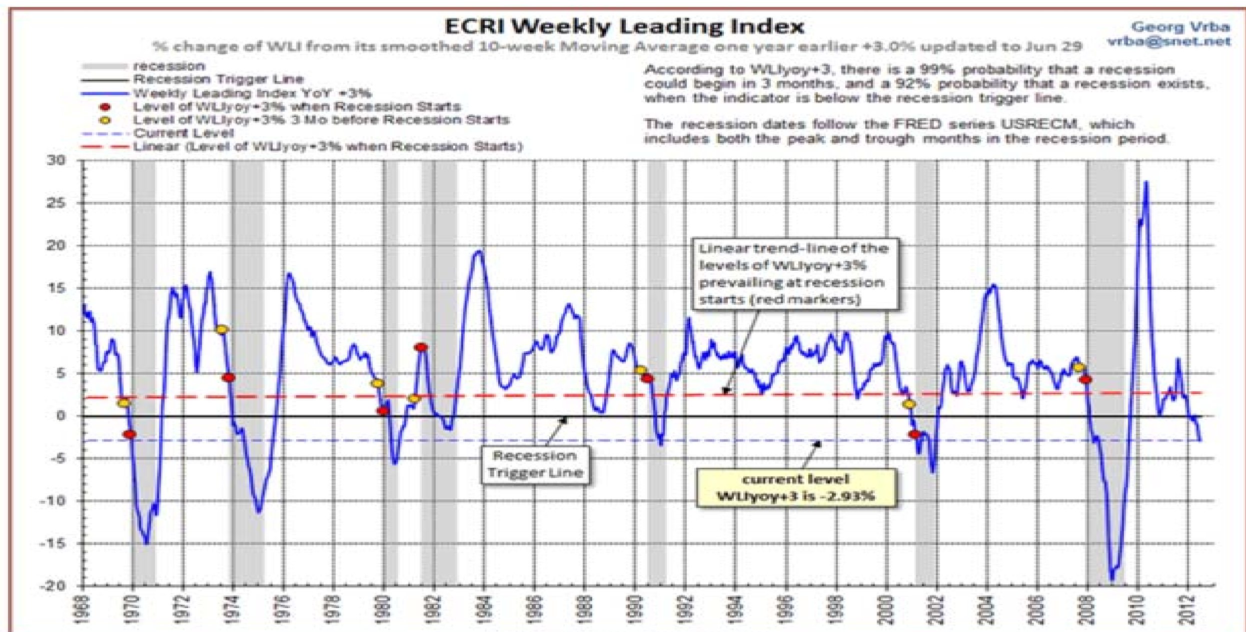
U.S. Recession May Be Imminent

The weekly leading index of the Economic Research Institute (ECRI) rose to 121.5. This indicator, as detailed in the graph below, shows a significant decline in the Weekly Leading Index (WLI). The WLI has been a leading indicator for six of the seven recessions since the 1960's. It lagged one recession (1981-1982) by nine weeks. The WLI did turn negative 17 times when no recession followed, but 14 of those declines were only slightly negative, and most of them reversed after relatively brief periods. Our latest call with ECRI revealed the following: A large component of this data series is "real personal income growth." Despite all of the Federal Reserves stimulus, actual U.S. economic growth including income and job growth, is slowing. In fact, in the last 60 years we have not seen a slowdown where year over year payroll job growth has dropped this low without a recession.



In the past 222 years the US economy has experienced 47 recessions, and we will experience more. It's simply part of living in a free market capital economy.

Collectively our team has seen a few recessions over the last 26 years or so. Whether we actually have entered one as I write this to you is not of too much consequence. As we have clearly stated in our communication, we would not be surprised by this, and knowing this, we are positioning portfolios for a "slow growth at best" time period. A more frugal allocation is necessary and although we do not make portfolio changes daily, we ultimately seek to look at weaknesses in asset classes which we may take advantage of by rebalancing or committing cash funds. Regular portfolio rebalancing, coupled with dollar cost averaging (when available) are the long term pillars of portfolio management.

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Although we may have concerns globally, we are reminded with the help of our friends like Dave Kotok, by what the 4th of July represents: Americas birth and independence enables us to enjoy great freedoms, we otherwise could not. Historically, in our colonized America, we attempted to have a currency called The Continental Dollar, and we inflated its value. We went through a system of currencies and monetary authorities that really were in the hands of several states. We fought a civil war. We endured repeated banking and credit crises. After the crisis in 1907 the Federal Reserve System was created. By 1913 it was official. Even at the first attempt of The Federal Reserve System it had its own faults. The obstacles we faced as a nation through the Great Depression and events leading to World War, we improved the functioning of the system. During the war, the Federal Reserve System was the financing arm for ultimately maintaining our independent nation, which ultimately lead to a better monetary structure through the 1950's, when we reached an accord and restructured the operation of the Federal Reserve System.

The Europeans are in the early stages of their currency. If it took us a century to figure ours out, it will likely take more than 15 years for The Eurozone to form their version of a united monetary system. There will be pains along the way but they will eventually emerge from their problems and become prosperous once again.

Have a healthy, safe and Happy 4th of July

JJ Burns, CFP
President and CIO

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