



4th Quarter 2011 Market Commentary

The Federal Reserve (Fed) left interest rates unchanged at the December 13 Federal Open Market Committee (FOMC) meeting, and repeated the outlook for “exceptionally low levels for the federal funds rate at least through mid-2013. Additionally, the Fed voted to continue the program to extend the average maturity of the Fed’s securities holdings, and continue to reinvest principal payments from its holdings of agency debt and agency mortgage-backed securities (MBS) in more agency MBS to support the housing market recovery. Finally, uncertainty related to the European debt crisis continues to keep Treasury issues well-bid.

Despite an unexpected drop in the national unemployment rate to 8.6% during November, monthly employment gains were reported below market consensus (+120,000 jobs compared to +125,000 jobs expected). However, the October employment report was revised higher (from +80,000 to +112,000), as the result of stronger private employment growth. Meanwhile, wage growth remains weak, despite the improving employment numbers. After a 0.1% drop in wages during November (compared to an expected +0.2% increase), year-over-year wage growth remains only 1.8%.

At the same time, overall consumer prices (CPI) are up 3.4% year-over-year, despite being unchanged during November. Excluding food and energy prices, core CPI was up 0.2% for the month, and is now up 2.2% over the last 12 months. Meanwhile, overall producer prices (PPI) increased by 0.3% during November (-0.3%), and are now up 5.7% year-over-year. However, core PPI, excluding food and energy, was up only 0.1% for the month, and is now up 2.9% year-over-year. With employee wages already lagging even core CPI, manufacturers are unable to pass along the large PPI increases to the consumer; limiting corporate profitability.

While November is traditionally the start of the holiday shopping season, retail sales were much weaker than expected for the month (+0.2% compared to an expected 0.6% increase). However, the October retail sales report was revised higher (from +0.5% to +0.7%). Additionally, November durable goods orders were much stronger than market consensus (+3.8% compared to +2.2% expected), and last month’s orders were revised higher (from -0.7% to +0.1%). Housing starts and building permits were also stronger than expected during November, although most of this growth occurred in multi-family units rather than single family homes. This recent data points to stronger fourth quarter GDP than was originally projected, but the final report on third quarter growth was revised lower, from +2.0% to +1.8%.

The yield of the current 2-year, 3-year, and 5-year U.S. Treasury Notes ended the month at 0.23%, 0.35%, and 0.81%, respectively. During the month, the 2-year ranged from 0.22% to 0.28%, the 3-year ranged from 0.33% to 0.43%, and the 5-year ranged from 0.80% to 0.97%.