

1st Quarter 2012 Economic Commentary

Signs of improvement emerged during the first quarter of 2012. The U.S. economic recovery gained ground and the European sovereign debt crisis finally began to abate – at least temporarily. The risk trade came back in vogue as investors rotated out of the relative safety of U.S. Treasuries and into corporate bonds and equities, driving U.S. interest rates higher and credit spreads narrower during the quarter.

Relief for the Eurozone began when the European Central Bank (ECB) offered unlimited liquidity to the European banking system through its Long Term Refinancing Operation (LTRO) introduced in November 2011. Banks obtained much-needed cash, sovereign issuers found buyers for their bonds, and investors regained their risk appetite. While ECB liquidity is only a temporary Band-Aid and does not address the underlying sovereign debt issues at the heart of the crisis, it was enough to instill a sense of relief in the markets and buy some time to address the fundamental problems. The EU cleared another hurdle later in the quarter when Greece obtained a second bailout package and successfully restructured its debt. Despite the respite, the health of the Eurozone remains a key concern. Spain is now in the spotlight as investors are wary about its ability to implement austerity measures while coping with slowing economic growth and rising debt costs. Greece will also return to the headlines as its May elections approach. There is concern that the elections could bring in a new anti-austerity/anti-Euro government, resulting in further financial instability. So while recent measures have helped to ease the strain on global financial markets, much uncertainty remains.

While Europe took a brief hiatus from the headlines, focus turned to the improving U.S. economy. Positive job growth resulted in further declines in the unemployment rate, and business and consumer spending picked up as confidence in the recovery increased. The housing market also showed signs of life as sales increased, property values began to stabilize, and mortgage rates held near record lows. Despite these recent improvements, concerns remain that modest GDP growth may not be sufficient to sustain the expansion, particularly in the labor market.

The Fed acknowledged the improving economy at its March FOMC meeting but communicated that the modest and uneven expansion would continue to require the support of a highly accommodative monetary policy. As a result, the Committee renewed its pledge to keep the fed funds rate exceptionally low through late 2014. In contrast to market expectations, the Fed did not discuss additional monetary easing options in detail at the March meeting. According to the meeting minutes, only “a couple of members indicated that the initiation of additional stimulus could become necessary if the economy lost momentum or if inflation seemed likely to remain below its mandate-consistent rate of 2 percent over the medium run.” The signal that QE3 was not right around the corner caused Treasury yields to rise. However, a lackluster March jobs report and Spain’s fiscal challenges have since reinforced the Fed’s extremely accommodative stance and revived market talks of QE3.

Although eager to embrace an improving picture, investors remain on edge about the sustainability of the U.S. expansion and fiscal reform in Europe. Will economic optimism prevail or does another summer slowdown loom ahead?