

# MILES *Capital* UPDATE

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**There may be trouble ahead  
But while there’s music and moonlight and love and romance  
Let’s face the music and dance  
-Let’s Face the Music and Dance, Irving Berlin, Composer**

“[Former Citibank CEO] Chuck Prince famously said we have to dance until the music stops. Actually the music had stopped already when he said that.”

-George Soros in the movie *Inside Job*

I have been asked frequently in recent weeks why the U.S. bond market has held up so well in the face of a potential debt crisis. We know that there may be trouble ahead – the very real chance of a near term default due to an impasse over raising the debt ceiling, and threats of credit downgrades by rating agencies – but still the Treasury market keeps dancing. In fact, yields on the 10-year Treasury have recently fallen below 3 percent, well off their high of 3.72 percent in February of this year.

By contrast, the sell-off in Greek bonds has spread across the continent, and this week yields on Spanish and Italian 10-year bonds crossed above 6 percent, their highest levels since the launch of the Euro in 2002. And, prices for gold – a traditional safe haven – continue to set new highs as well. How can that be?

In our view, U.S. bond yields have remained low for three reasons: First, the U.S. dollar remains the world’s reserve currency and for most investors a U.S. Treasury bond remains the “gold standard” (pun intended) for return of your money if not return on your money just now.

Second, investors are not yet willing to believe that the world’s only remaining superpower, a nation that has never defaulted on its debt, would knowingly and intentionally default on its debt when it could readily pay – despite the political rhetoric.

Evidence for this second point comes from a look back at the 1995-96 debt crisis. The federal government hit the debt ceiling in November, 1995, leading to a two day shut-down that month, and a second shutdown from December 15, 1995 through January 6, 1996. Then, as now, Moody’s warned of a downgrade, while the Treasury Secretary found ways to issue debt that did not count against the debt ceiling, and negotiations went on for months.

What happened to Treasury yields? For the first three months of the debt ceiling crisis Treasuries actually rallied, with yields falling (in conjunction with Fed easing) by roughly 50 basis points (bps). As the crisis wore on however, patience for a solution eventually wore out, and yields on 10-year Treasuries increased 80 bps in less than a month. In late March 1996 the ceiling was raised.



David Miles  
Chief Executive Officer

Importantly, the federal government did not default in 1996. Ultimately investors’ confidence in their elected officials proved justified. And so that faith remains intact this go ‘round. Equally important, in today’s timeline we are closer to March 1996 than to November 1995. The Treasury Secretary has few arrows remaining in his quiver. But market sentiment remains strong – so far.

Finally, monetary policy is committed to keeping yields low. The anchor for rates is a Federal Funds target of 0 – 0.25 percent, which means that the current spread of 250 bps between the 2-year Treasury and the 10-year Treasury is already at record levels. Until the end of June, the Federal Reserve’s second round of quantitative easing meant it was purchasing such a large share of all new Treasury issuance, that net new Treasury issuance in the first half of 2011 was minimal. And, even though “QE2” has come to an end, the Fed is still rolling income from its portfolio of mortgage-backed securities into Treasury purchases, and has left no doubt that it is prepared to take further steps to ease monetary policy if needed. Taken together, these Fed actions – along with constrained new issuance while the debt ceiling debate goes on – create a formidable barrier to higher Treasury yields in the near term.

And so the dance goes on. Treasury yields remain extraordinarily low. The immediate threat, of course, would be

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## There May be Trouble Ahead (continued)

a failure by Congress and the Administration to address the debt ceiling, resulting in the first ever default by the United States. In that case we too will find that we have been dancing long after the music stopped playing. We concur with most market participants that such an outcome is a remote possibility.

But as necessary as it is to deal with the debt ceiling (and soon), it is not sufficient to address the looming debt crisis

headed our way in the not-too-distant future. The United States' public finances are on an unsustainable path.

More on that in a future newsletter.



David W. Miles  
Chief Executive Officer

## Economy: "Greece" Lightning

The challenge of generating growth continues as Greece moves closer to default and Congress moves closer to election season. Greece has consumed headlines for months as the government wrangles with austerity measures that will keep the bailout flowing, but the heat is rising in the form of citizen revolt which could ultimately lead to default.

The U.S. Treasury market is the beneficiary of this turmoil but investors are wary of the steep price being paid for safety as we wrestle with our own need for fiscal discipline. Debate around the debt ceiling is focused on whether an acceptable solution can include raising taxes. Polarization of our political system has encouraged legislators to stand hard on their positions rather than make meaningful compromise. The debt ceiling issue will be resolved without a U.S. default, but many in Congress may be surprised in 2012 at voter reaction to their grandstanding.

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Domestic growth is in its eighth quarter and should improve through the remainder of the year as temporary headwinds dissipate. Supply chain disruptions from the earthquake and tsunami in Japan lasted longer than many anticipated, but much activity has resumed. And gas prices have retreated from their highs which will give consumers more power to spend.

The conclusion of quantitative easing by the Fed has been largely a non-event given how well it was telegraphed to the markets. Monetary policy has been extremely accommodative for a long time, yet inflation remains tame, so there is room for growth without adverse consequences, at least for a while. However, until job creation begins in earnest, growth will be subdued.

We are waiting for resolution to some far-reaching issues (i.e., Greece and the debt ceiling), but remain optimistic that another recession can be avoided. In the meantime, risk management remains our focus.

## Equity: Concerns Lead to Market Pause

As a result of optimism regarding the global economic recovery, the equity market continued its ascent early in the second quarter, with the S&P 500 Index rising nearly 3.0 percent in April and 8.4 percent in the first four months of the year. However, in early May the optimism began to wane amid a host of weak economic reports and renewed fears that Greece would default on its debt obligations. The coming end of the Federal Reserve's quantitative

easing program and grid-lock in Washington about the U.S. debt ceiling also fueled concerns that an economic and equity market slowdown was soon approaching. The rapid change in sentiment led many equity indices to retreat to levels near those at which they began the year. Nevertheless, an easing of fears in late June sparked a quick rally, leaving the Index up 5.0 percent for the first six months of the year.

## Equity (continued)

Despite the recent surge in the market, concerns about the sustainability of the move abound. Continuing weakness in employment and housing have led many economists to lower their GDP growth estimates for the U.S. in recent weeks. While the ending of the Federal Reserve's quantitative easing program is not likely to trigger a prolonged market decline, the political impasse in Washington is seen by many investors as a hindrance to sustainable economic and equity market improvement. Although it appears that a fiscal crisis in Greece has been averted in the near term, a long-term solution to the European sovereign debt situation is no more apparent today than a year ago. Needless to say, any alignment of political policy with economic reality on either continent would be welcomed by investors.

In emerging market economies, central bankers continue to succeed in controlling inflation through monetary policy adjustments. In China, a blend of interest rate hikes and lending restrictions have reduced economic growth and eased inflationary concerns. However, growth and inflation are still running above the targeted rate, suggesting that further adjustments are likely. If all goes well, the economic fine-tuning will result in a slower but more sustainable growth

trajectory, supporting the global equity market well into the future.

In the short term, slowing growth in emerging markets and continuing sluggish growth in developed markets could lead to a modest market pullback and more volatility as investors calibrate their portfolios to better align with expectations of slower global growth. Even though signs of economic deceleration are abundant, we do not expect the U.S. or global economy to return to a recession. While economic headwinds may limit the upside of the equity market through the remainder of this year, the market downside also appears to be limited due to the low interest rate environment and strong financial position of most large corporations.

Beyond 2011, we expect to gain more clarity on the economic situation in the U.S. and abroad. As we move into 2012, it will be more apparent whether or not key emerging market countries are achieving success in engineering a "soft-landing" after years of high growth and inflation. With greater clarity on these issues comes higher probability of stocks resuming their advance, although at a slower but more controlled pace.

## Fixed Income: Not So Fast

The market reminded investors during the second quarter not to get ahead of themselves regarding the economic recovery. A number of challenges still remain across the globe and U.S. economic results have lagged expectations over the past few months. These and other issues drove investors into higher quality assets throughout the quarter.

U.S. Treasury securities were the biggest beneficiary of this shift as interest rates, as measured by the 10-year U.S. Treasury bond, declined considerably during the quarter hitting a low near 2.8 percent in June, the lowest level since last December. Rates rebounded in the final days of the quarter finishing near 3.1 percent. The difference between long-term interest rates and short-term interest rates remains at historically high levels and we expect this will hold true for at least the next few quarters.

As investors shifted allocations within the fixed income markets, spread sectors including corporate bonds underperformed similar duration U.S. Treasuries. Within corporate bonds, the financial sector underperformed as uncertainty regarding a possible Greece default and other headlines negatively impacted the industry. Even with the recent pullback, corporate bonds continue to offer good relative value given their strong fundamental and earnings trends. Other spread sectors, including municipal bonds and agency residential mortgage securities experienced solid performance for the quarter as investor demand outpaced supply for these sectors.

The recent soft patch serves as a reminder that a recovery in the economy and the markets will not be a straight line and that investors should expect volatility to continue. Many of the factors impacting recent weaknesses appear to be temporary and should subside over the coming quarters.

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# Miles Capital Developments

**A**t Miles Capital, we remain focused on continuing to develop our processes, solutions, and services to better meet our clients' needs. We recently distributed our 2011 client survey to request feedback on what services and solutions clients feel would better help them achieve their goals. Thank you to all who have completed the survey. We have received some great, useful feedback. If you have not completed it, please consider doing so. This is a direct effort to maintain our responsiveness.

In addition, we have several other developments to mention that are direct results of previous client feedback:

- In June we launched our new website. While we still have some build-out to do, this is a direct response to requests to make our site more accessible. Please visit us at [www.miles-capital.com](http://www.miles-capital.com).
- Our new All-Cap Equity Income (previously discussed as "Diversified Equity Income") is up and running and off to a great start. We recognize that in the current market environment, increased income grows ever more important to investors.
- The Miles Capital Asset Allocation Committee

continues to analyze the investable world market asset classes to provide value to our clients. Our proprietary methodology is firmly established and the team is implementing additional asset classes as appropriate.

- We have instituted a successful internship program for students with goals in asset management. More will be coming soon to our website from the interns regarding exciting developments in capital efficiency modeling and customized benchmarking for institutional clients.
- Miles Capital provides investment advisory, administration and fund accounting services to several Local Government Investment Pools across the country. We have recently been selected as investment advisor of the Oklahoma Public School Liquid Asset Pool. In addition, our proprietary program developed exclusively for educational institutions - IPASeducation will undergo a name change soon by popular demand.

We are committed to keeping you updated on the developments at Miles Capital. As always, please contact us at 800-343-7084 if you would like to visit with any of our team members.