

# MILES *Capital* UPDATE

## In This Issue

- 2 | Economy: Muddy Waters
- 2 | Equity: Positive Ending to a Volatile Year
- 3 | Fixed Income: End or Eye of the Storm?
- 4 | Miles Capital Asset Allocation

## The Delicate Matter of Deleveraging

Leverage is a wonderful thing. Good times get better. Average times take on a rosy hue. And even bad times lose much of their sting.

Yes leverage is a wonderful thing – until the time comes when that leverage must be repaid; particularly when the collection bell rings unexpectedly early, or at a terribly inconvenient time. And the most inconvenient time is when a global credit bubble bursts, as it did in 2008, because asset values evaporate at the same time that debts come due. Indeed, debts often come due *because* asset values have plummeted.

By now we know well the near term impact of the recent financial crisis: the first worldwide recession since the 1930s. But some 2 ½ years after the formal end of the recession in the United States, the longer-term challenge – repayment of unsustainable levels of debt – remains largely unaddressed.

And so as we enter 2012 the topic of “deleveraging”, which was scarcely uttered pre-2008, is on everyone’s lips.

Where exactly is all this debt that we need to address? It is largely centered in the developed-market economies, and while it varies from country to country, the credit bubble was largely driven by household debt and financial sector leverage. Rising real estate prices were both a cause and a consequence of increased household and financial debt. Importantly, public sector debt – which was flat or declining prior to the crisis – has since been driven sharply higher by efforts to stimulate economic growth.

Scarcely anyone disputes the need to lower total debt levels in the world’s developed economies, and ideally we would grow out of it. But, as we will see in a moment, that is difficult to do. Of course no one wants a “disorderly” deleveraging. But neither can the developed world continue with unsustainable levels of debt (private or public).

In a study of 32 episodes of deleveraging following a financial crisis since 1950, the McKinsey Global Institute identified four archetypes of deleveraging:

- 1) “Belt-tightening” – a prolonged period of austerity, where debt lessens slowly; this is the most common path following a debt crisis;
- 2) “High inflation” – high nominal GDP growth reduces debt/GDP levels; rare in the presence of a strong and independent central bank;
- 3) “Massive default” – often after a currency crisis; a primary concern with respect to Europe; and
- 4) “Growing out of debt” – the rarest form of deleveraging; often the result of an oil boom or the stimulative effects of a war effort.



David Miles  
Chief Executive Officer

If rapidly growing out of debt is unlikely, then the least disruptive – and in most respects most desirable – form of deleveraging is “belt-tightening”. But belt-tightening takes time – typically 6-7 years or more. And, it can be quite challenging to generate positive nominal GDP growth while reducing debt because typically consumption declines, which reduces business demand and investment, and in turn reduces tax receipts to address public sector debt.

At times such as these there is considerable political conflict between those that look to the public sector to stimulate economic growth, and those that favor reducing public spending more quickly to restore financial discipline. This uncertainty makes investing unusually difficult, because how deleveraging occurs and at what pace may lead to dramatically different outcomes across various asset classes.

This much we know – deleveraging will occur. In fact it has been occurring in the private sector for some time. And deleveraging will impede GDP growth. For now we see the most likely outcome to be slow economic growth (but growth nonetheless), and continued low interest rates. And in this

continued on page 2

## The Delicate Matter of Deleveraging (continued)

environment we favor high quality investments generating high current income, and, where we can find it, above-average growth.

The greatest wild card remains Europe, as we see whether they can simultaneously roll maturing debt, implement needed austerity measures, and limit the negative impacts on near term

economic growth. We all have a stake in their success.



David W. Miles  
Chief Executive Officer

## Economy: Muddy Waters

**T**he turn of the calendar always brings hope: for clarity, for prosperity, for peace. We wish for these things, but uncertainty abounds heading into 2012. Of primary concern is the European situation and the potential for contagion that spreads beyond the means to prevent destruction of wealth and political systems.

Greece remains on the brink of default, but Italy and Spain are the real worries given the sheer amount of debt outstanding and the concentration held by European banks. Defaults by either or both would shake the global financial system and could push the world into recession and extended economic malaise. EU Finance ministers agreed in December to a framework for holding the European Union together, but the devil will be in the details and volatility will follow.

On the homefront, economic indicators have moved higher suggesting the growth story is intact. The unemployment rate dropped to 8.6 percent, ISM service and manufacturing

activity surveys ticked up, and retail sales for the holiday season were encouraging. While activity is far from robust, GDP growth of 2-3 percent in 2012 would be a welcome improvement.

Market cycles are getting shorter and volatility is ever-present.

Outside of Europe, the geopolitical landscape is changing with the death of North Korea's leader and increased speculation that Iran has nuclear weapon capabilities. Tensions in many Middle Eastern countries are elevated as a result of Arab Spring unrest. And the upcoming U.S. election encourages political gridlock.

Uncertainty on many fronts will likely leave interest rates anchored at historically low levels and keep a lid on economic growth.

Market cycles are getting shorter and volatility is ever-present. We look through the noise to craft long-term solutions and rely on our risk framework to keep portfolios on track. We appreciate the opportunity to guide you through these muddy waters and look for more clarity in 2012.

## Equity: Positive Ending to a Volatile Year

**T**his was a year equity investors will not soon forget. Market volatility was elevated due to the nuclear meltdown in Japan, uprisings in oil-producing states in the Middle East, S&P's credit downgrade of the United States, and the threat of dissolution of the European Union (EU). Nevertheless, U.S. economic indicators made modest improvements and the stock market finished strong, with the S&P 500 Index closing the year up 2.1 percent.

Consistent with investors favoring larger stocks over the last twelve months, the Dow Jones Industrial Average closed the year in positive territory, up 5.6 percent. Given the high volatility in the market, it is no surprise that the leading sectors for stocks were Utilities, Consumer Staples, and Healthcare.

With healthy corporate earnings, inflation in check, and U.S. economic data improving, the equity market appears to be well positioned for further appreciation. However, investors are curbing their enthusiasm due to lingering risks.

In the U.S., political gridlock continues, with the Congressional "Super Committee" doing little in November to address the country's fiscal imbalances. And, with the 2012 election cycle beginning to accelerate, it appears unlikely meaningful economic reforms will be achieved until next year at the earliest. Given the political environment, many investors are wondering if recent improvements in consumer and business confidence levels are sustainable. Fortunately, corporate balance sheets and profits remain strong, supporting

## Equity (continued)

further improvement in unemployment. And, low interest rates and lack of inflationary pressure increase the probability of slow but sustainable economic growth, providing a favorable environment for the U.S. equity market.

In Europe, leaders continue their halting steps toward addressing sovereign debt problems. Although the moves added stability to the European banking system, investors are reserving applause until members of the EU begin addressing the real problem – sovereign debt. In particular, investors await implementation of measures to “ring-fence” Spanish and Italian debt, thereby reducing contagion risk. Also, investors are waiting for EU members to draft and enforce a common set of budgetary rules necessary for achieving greater fiscal discipline. At this point, the main question on investors’ minds is, “Will these measures be implemented in time to avert a global economic slowdown?” Clearly, such a slowdown would not be good for the global equity market.

Slowing growth in emerging markets has also fueled caution among equity investors. During the fourth quarter, concerns

grew that China’s economy may be slowing more than expected, led by a decline in European exports and real estate activity. In response, Chinese officials recently implemented more accommodative monetary policies, including lowering bank reserve requirements, supporting lending. Leaders in other emerging market economies are initiating similar measures to manage inflation and economic growth, improving the outlook for global equities.

As we move into the new year, global economic headwinds present a challenging environment for equity investors. Although economic conditions are improving slowly in the U.S., the equity market is likely to remain volatile given the financial stress in Europe and concerns about a slowdown in China. Nevertheless, the global economy is well positioned to deliver modest, but positive, growth. In the major global economies, inflation is in check and monetary policy remains very accommodative, enhancing corporate earnings prospects and consumer spending. Given attractive valuations, equities will likely be the asset class that benefits most when stronger signals of global economic improvement emerge.

## Fixed Income: End or Eye of the Storm?

The fixed income markets have resembled a hurricane during the past few quarters with tremendous volatility and winds shifting directions without much warning. The biggest question that remains is if we are emerging from the storm or do we find ourselves in the uncomfortable calm of the eye? Only time will tell, but from our perspective it appears the sun is trying to emerge through the economic storm clouds.

The fourth quarter began with winds blowing in a positive direction as optimism surrounded a proposed resolution in the European sovereign debt crisis, but the markets quickly realized that details would prove difficult to resolve. The situation in Europe will continue to be in the forefront of investors’ minds and concrete resolutions will take time to implement. In addition, the political situation in the U.S. continues to create uncertainty for the markets.

Interest rates, as measured by the 10-year Treasury bond, moved within a broad range during the quarter and ended very close to where they started at 1.9 percent. In fact, looking at interest rates across various bond maturities, the interest rate curve was little changed. For the year, interest rates

experienced significant volatility while declining over 1.5 percent as measured by intermediate and longer maturity Treasury rates. This decline resulted in strong total returns for most fixed income securities in 2011.

While total returns were positive, relative performance within various sectors of the fixed income markets experienced wide divergence. For the quarter, risk premiums generally improved resulting in the outperformance of corporate bonds, mortgage securities, and municipal bonds when compared to similar duration U.S. Treasuries. But over the entire year, these same “spread” sectors largely underperformed U.S. Treasuries as the flight to safety trade drove prices of the Treasury securities up significantly. In particular, corporate bonds and especially financial services companies bonds, suffered the largest relative underperformance.

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Weathering the global storm will take some time given the magnitude of the issues, but the markets will eventually return their focus on the fundamentals that drive long-term performance for investors. We look forward to helping our clients successfully navigate through these challenging times into 2012 and beyond.

# Miles Capital Asset Allocation

It is no secret, and research continually demonstrates, an investment portfolio's asset allocation determines the majority of long-term performance, the volatility of portfolio returns, and risk characteristics. Strategic asset allocation is fundamental to long-term investing.

Miles Capital has offered investors an Asset Allocation Program (known as MCAP) to clients for the past five years. While the program has evolved with the marketplace, our basic philosophy of providing diversified asset class exposure consistent with each investor's risk profile and investment time horizon remains in place.

A disciplined asset allocation program offers investors a variety of benefits:

- 1) The use of multiple asset classes enhances portfolio efficiency. Historical asset class data demonstrates the long-term asset class return potential, correlations, and benefits of diversification.
- 2) Efficient asset class exposure to asset classes consistent with the world market is now readily available to all investors.

- 3) Focused rebalancing parameters remove the impact of investor psychology and affirm "reversion of the mean" by enforcing the act of selling high and buying low.

The Miles Capital Asset Allocation Program (MCAP) offers investors risk-based asset allocation portfolios. Each asset allocation portfolio represents the unique risk tolerance and investment needs of investors and ensures efficient asset class exposure through active or passive investment vehicles.

MCAP was built, and is continually refined, by the Miles Capital Asset Allocation Committee. The committee reflects a team of tenured investment professionals with an extensive analytical tool set to evaluate asset class performance, market dynamics, and investment vehicles. The asset allocation portfolios crafted provide investors with asset class breadth, proper diversification, and enhanced return potential.

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.