INVESTMENT UPDATE
NEWSLETTER
ALLEN TRUST COMPANY

JULY 12, 2012

William A. Harris, CFA
Chief Investment Officer

At Midyear, Renewed Volatility and Burgeoning Scandal

Spring brought renewed instability in global stock prices. US equities again outperformed, beating their foreign counterparts for the three months ended June 30, but they did so on losses nonetheless: the S&P 500 Index gave up -2.8% versus a -7.2% loss on the MSCI World Ex-US Index. While Europe's problems grabbed the headlines, softness in emerging market heavyweights China, Brazil and India has been forming a troublesome backdrop for the global economic outlook.

Meanwhile, bonds managed to find their footing after a flat first quarter, with the BarCap US Aggregate Bond Index clocking a 2.1% total return in the April-June period. Indeed, here in early July, we see bonds priced high at yields so low (please recall the inverse relationship between bond pricing and bond yields) that even ardent bond bulls should admit the skimpiness of Treasury rates, with the 10-year benchmark paying less than 1.5% and yields on TIPS now negative out to 20 years. Vaporous yields mean vulnerability to rate shocks, and though we doubt the day will come soon, we firmly believe that an unhappy reckoning waits for the unprepared bond investor a few years down the road.

The 2nd Quarter also found the formerly unassailable JP Morgan with egg dripping from its face, as it acknowledged a multi-billion dollar loss on a hedge trade gone bad. The importance of this is not the size of the loss (which by itself JP Morgan can absorb), but rather the vivid illustration of how utterly things can go wrong at the heart of finance as it operates today, with systemically important (not to mention taxpayer backstopped) institutions still taking on risks of a complexity and peril akin to business as usual in the run-up to the Fall 2008 financial crisis.

Further undermining confidence in big financial institutions, late June revealed that Barclays has tried to rig rates in the London Interbank Offer Rate (LIBOR) market for years. This has yet to ignite the outrage it should for a few reasons: 1) it opened with an air of *fait accompli* because regulatory wrist slaps had already been administered, 2) the details involved are sufficiently abstruse and soporific to keep most people from comprehending the headlines, much less reading beyond them, and 3) this was essentially an exercise in skimming, a connivance which by design attracts little attention because of the proportionally small increments being raked off at any given time.

Make no mistake though, LIBOR is hugely important as <u>the</u> reference rate for trillions of dollars in commercial and consumer loans and mortgages, and for hundreds of trillions of dollars in financial derivatives. If it turns out that other firms were similarly manipulating LIBOR – or putting their thumb on the scale with other rates, instruments, or commodities – the realization could be acutely destabilizing for the markets.

Our great concern is that when incentive intersects with opportunity, incidences like this are unlikely to be isolated; the cockroach you see when you switch on the light is not the only cockroach. Even in the aftermath of the Fall 2008 crisis, incentives have remained perverse and moral hazard ongoing, as bank executives still receive astronomical bonuses when risks pay off, yet don't share in losses when risks go bad; and opportunity has been found in regulators' slowness either to act or grasp the dynamics of what's really going on, or in their willingness to look the other way.

We are steering clear of financial services stocks and prefer cash to heedless speculations.