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## *Tightening*

### **KEY POINTS**

- *We continue to see slow economic improvement.*
- *The economic word of the day worldwide is “tightening.”*
- *Europe, the United States, and China continue to struggle with headwinds.*
- *Municipal credit research will increase in importance.*

Wednesday saw the announcement that U.S. industrial production grew in January, continuing a rebound that began in the second half of 2009. An uptick in inventory-building by U.S. businesses boosted output. The housing starts and permitting news released Tuesday by the National Association of Home Builders was also positive. Additionally, over the last few weeks, a number of developed nations released retail sales figures showing modest recoveries. Despite the improvements in industrial production, housing starts, and retail sales, which tended to bottom in May 2009, all of these economic indicators remain well below their peaks. Industrial capacity utilization, while approaching 73%, is still well below the longer-term average of more than 80%. While home sales overall have stabilized near their normal levels, almost all sales of late have involved existing homes; almost no new homes have been sold and that trend might continue for some time. While retail sales have improved, they are still well below the levels we saw before the crisis. In fact, at the current growth rate in global retail sales, Bridgewater estimates that it would take more than a year and a half to get back to pre-crisis levels. These figures highlight the importance of the federal government's various efforts to stimulate the economy. They also point out that private debt creation is critical. We are encouraged by the improvements these and other indicators are showing, but their low absolute levels lead us to conclude that the economy remains fragile.

### ***Check your seatbelt***

Even though the recovery is fragile, some central banks are signaling that tighter monetary policies are on the way and some central governments are signaling that tighter fiscal policies are nigh. We believe emerging economies may be better positioned than developed economies to withstand at least some forms of these policy changes.

Starting a global tightening survey, we see actions by the Greek and Spanish governments in light of their current economic situations and the pressure being applied by members of the European Union, especially Germany. In particular, Spain announced an austerity plan of surprising size; the combination of reduced spending, a higher retirement age, and other concessions were on par (in terms of gross domestic product) to the stimulus bill President Obama signed last year, though in reverse. For the second time in a month, China moved to curtail bank lending by increasing its reserve requirements; this is in addition to an interest rate hike announced last month. In the United States, the Federal Reserve has stayed the course by drawing to a close certain programs designed to support the credit markets, most notably the

mortgage-backed market. The notes of the January meeting of the policy-setting Federal Open Market Committee indicate that several participants “thought it important to begin a program of asset sales in the near future to ensure that the Federal Reserve’s balance sheet shrinks more quickly . . .” Further, we have the move yesterday by the Fed to increase the discount rate, the interest rates charged on loans to member banks, by 25 basis points (0.25%). Given where most developed economies currently stand, tightening would seem to be the last thing on the minds of the electorate and bankers. We are, however, seeing material support for greater fiscal conservatism. EU member-states appear to be accepting the notion that some reduction in government spending, even in the face of high unemployment and sluggish growth, is necessary if the Union is to survive. In the United States, the long-run trend rate in government spending easily eclipses the growth in median household income, and it seems most Americans are uncomfortable with that. We still do not think more overt tightening, such as an increase in the Fed’s target for short-term interest rates, will be seen in the near future, but certainly tightening in other forms is here.

Tightening does not augur good times for risky assets, which have benefited mightily from the increased market liquidity, low interest rates, and propped-up levels of economic output that governments worldwide have engineered. The question is not whether government spending must be reduced from the levels we have seen over the last year but, rather, is the global economy healthy enough for austerity measures to begin now? Unemployment is still high in most developed countries and economic growth is sluggish at best. The sovereign debt problems in Europe appear likely to shake both central banks and the financial sector, with implications for emerging economies. Furthering the difficulties of their developed but heavily indebted brothers, emerging economies have the opposite problems of very rapid growth and little appetite to address their internal economic pressures. The United States claims China continues to hold the yuan at artificially low levels, negatively impacting the U.S.-China trade imbalance. We believe that, in the end, significant tightening will be almost impossible to maintain and, where they can, central banks will print money to make good on national debts. There is uncertainty as to the near-term actions of central banks, and financial markets are bound to remain volatile because of it. We don’t kid ourselves, or you—it will be a very bumpy ride for investors in 2010.

### ***Homework required for municipal bondholders***

It has been no surprise that, as the economy contracted, the revenue base for many municipalities—from income taxes to property taxes to other revenues from myriad projects—shrunk as well. Much of the early stimulus that was directed to municipalities has slowed. Members of the fourth estate have played this song repeatedly, with news reports suggesting that a major spike in Chapter 9 bankruptcy filings is likely. Certainly, it is fair to say that there is a divide between “safe” and “risky” assets—especially among municipal securities, which vary in quality far more than casual observers might expect. The only true way to address the quality chasm is through old-fashioned credit research. The real value of active municipal bond management, by an experienced and deep team of professionals, becomes clear in times like these. There will be more issues and problems within the tax-exempt space, but there will also be opportunities for those who are able and willing to do their homework.

All of this leads us to continue to watch risky assets closely. Central government and central bank activities, as well as the continuing stream of economic news, are in our sights daily. We don’t expect to divine the best time for investors to reduce risk in their portfolios, but we are prepared to make a move related to risk and risky asset exposures should conditions warrant.

# MARKET NOTES



Source: Board of Governors of the Federal Reserve System (industrial production)

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