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CLIENT BULLETIN

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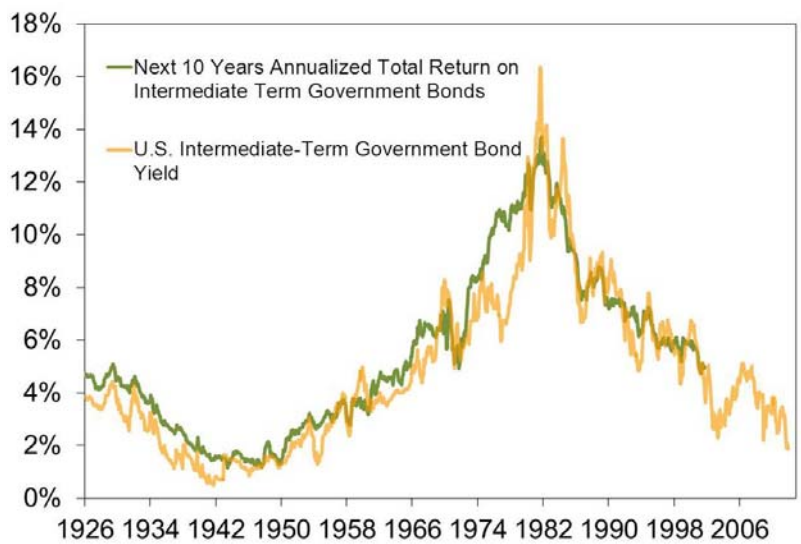
➢ *Bond Ballast*

Bonds have historically played an important role in a diversified investment portfolio as a relatively stable form of ballast in turbulent times while delivering high single-digit returns. In this case, however, past may not be prologue to the future. Bond performance is inversely related to the direction of interest rates. As interest rates decline, bond prices generally rise as the fixed income that a bond pays becomes more and more attractive. For the past 30 years, bonds have received a "tailwind" of investment performance as interest rates have generally declined over that period.

➢ *Bond Blues?*

Sitting as we are at a historically low point in the interest rate cycle, it is a fairly safe assumption that at some point interest rates will begin to rise. As this occurs, bonds will face a headwind of generally declining prices which will offset the fixed income they generate. In addition, the income they currently generate is very low. The chart at right illustrates this point. It plots the current yield of government bonds (yellow line) against the **next** ten year annualized return for government bonds. As you can see, there is a very strong correlation between the starting point of interest rates and future bond performance. This does not mean that bonds will be a useless asset class going forward and there are ways to mitigate this risk within a bond portfolio, but mathematically it is going to be very difficult for bonds to make as significant a contribution to inflation-beating returns in the coming decades as in the past.



- ***Europe – Drama or Tragedy?***

The economic upheaval overseas seems to never end. The past few weeks have seen another change in the Eurozone's political-economic complexion. A shaky consensus toward government fiscal austerity (i.e. the adult understanding that you can't indefinitely spend more than you make) has reversed course following political elections in France, Greece and the Netherlands among others. The original austerity movement was always a German matter since Germany, as Europe's largest and healthiest economy, was and is destined to carry the burden of any bailout of weaker nations in the Eurozone. On the other end of the spectrum is the simple rejection of the pain implicit in any government spending cuts and denial of the long-term issues. This movement is represented by Socialist French president Francois Hollande and anti-austerity movements in Slovakia and Holland.

- ***Europe II – Threading the Needle***

Either approach taken to the extreme promises only one kind of disaster or another. Addressing government deficits solely with budget restraint could further weaken European economies at a critical juncture, while simply ignoring budget imbalances and continuing to over-spend would merely extend the policies that brought these economies to the current disastrous state. The only sane response to Europe's situation is a balanced, structural approach that encourages economic growth while reducing government spending. Germany took this approach in 2010 by lowering bureaucratic hurdles for new business creation, setting higher retirement ages and cutting government regulation. The result has left their economy stable and healthy amid the turmoil. The rest of Europe (and the United States in the not-too-distant future) would do well to pay attention to a formula that is proven to work.

- ***Not So Golden State***

Speaking of out of control spending, California recently announced that it is looking at a $15.7 billion deficit, not the $9 billion it forecasted just a few months ago. This deficit figure represents about 17% of revenues. California has made slower progress than most other states in recovering from the financial crisis and still has an 11% unemployment rate vs. 8.1% nationwide. With one of the highest tax rates in the nation already, this is clearly a spending problem. Instead of stress-testing the big banks, anyone for stress-testing state governments?

- ***Greece – Exit Stage Left?***

Greece faces another significant election on June 17th. If "anti-austerity" parties garner enough votes it could endanger Greece's membership in the Eurozone. This move could include a forced conversion of euros currently held in Greek banks to a "new" drachma at a substantially devalued level. This would be a disastrous result for Greece with accelerating withdrawals of Euros from Greek banks. If the Greek election strongly favors "pro-bailout" parties, however, then progress could be made toward a long-term solution for combined Europe while Greece, a very small part of the Eurozone economy, would merely remain in a depressed state economically. Stay tuned.