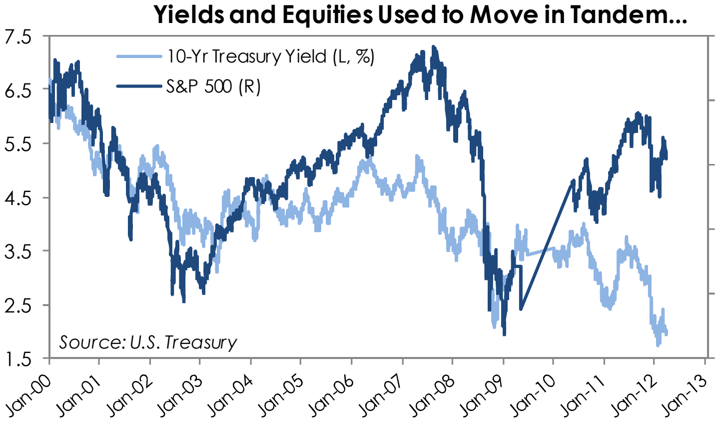
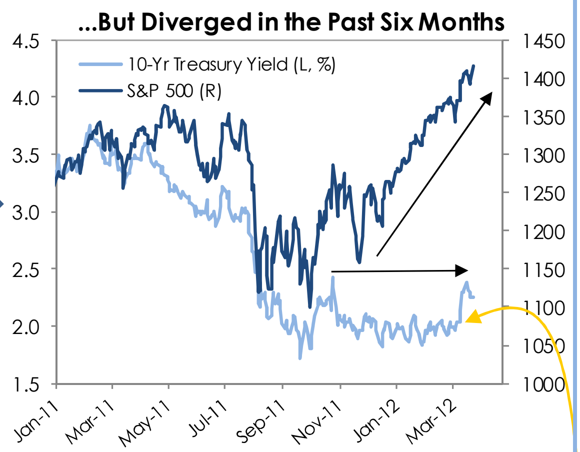
MIRACLE MILE ADVISORS

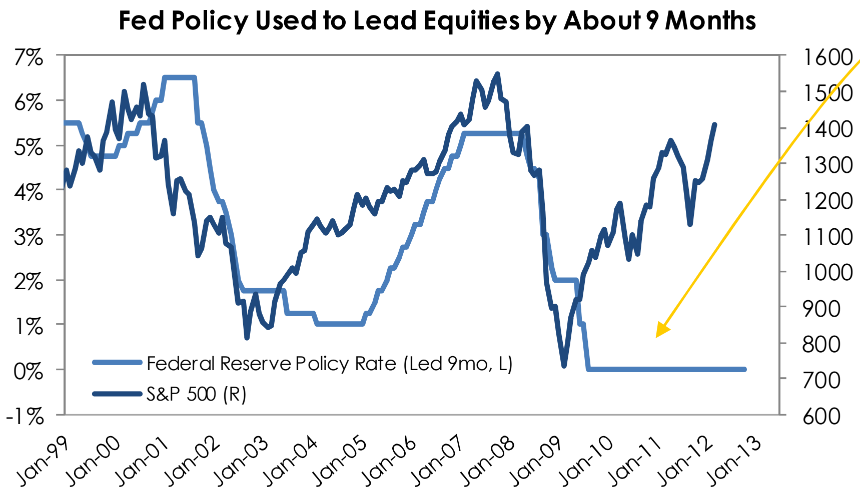
March 2012

Miracle Mile Advisors Research Spotlight: Fixed Income





Equities and Treasury bond yields have diverged over the last several months, but prior to that they moved in the same direction for most of the last decade. This relationship was intuitive: equities rise when investors want to take on risk, which drives bond *prices* down and *yields* up. The opposite occurs when risk aversion rules and bonds appeal to investors looking for a safe haven. Recently, this positive correlation has broken down; while equities have rallied, bond yields have gone almost nowhere and hovered at historically-low levels. A few weeks ago, however, yields tried to break out of their holding pattern and rose briefly. What changed in the last six months and then again in the last few weeks? The answer lies in Federal Reserve bank policy.



The Fed's policy rate has been set at zero since 2009, while bond yields still reflected risk taking/risk aversion until the last several months.

Since former Fed Chairman Paul Volcker "broke the back of inflation" in the early 1980s the main factor in determining the path of interest rates – and bond yields – has been monetary policy. This relationship has changed since the central bank anchored its benchmark policy rate at zero during the financial crisis. The Fed's dual mandate of price stability and full employment demands that it weigh both of these goals when setting policy, so at the time flooding the market with liquidity to avoid deflation and promote growth was appropriate. Despite ZIRP (Zero percent Interest Rate Policy), bond yields still moved in line with stocks (and the business cycle) during the equity market rallies in 2009 and 2010. During those periods investors thought the Fed would soon remove its floor on interest rates as the economic backdrop improved. However, the deleveraging occurring across the US economy has muted the recovery and the Fed clearly has chosen to err on the side of stimulus.

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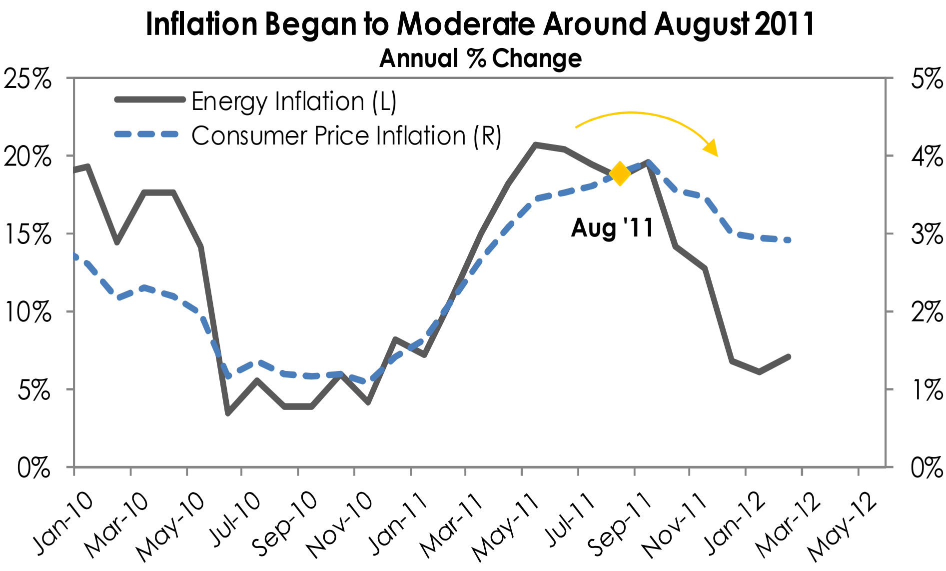
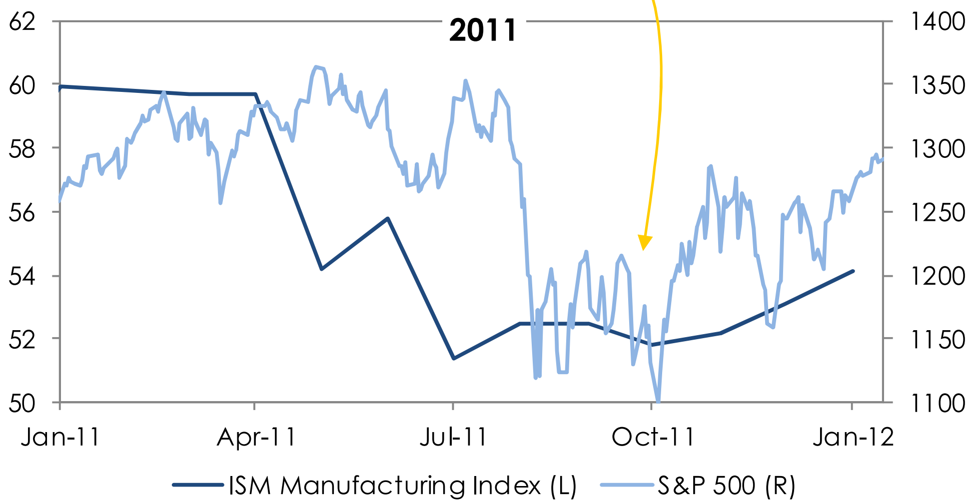


A break between bond yields and equities occurred around the time – August 2011 – when Fed Chairman Ben Bernanke assured the financial community that the central bank would leave ZIRP in place at least until mid-2013. The markets took the Chairman at his word for the next several months, particularly since the outlook for the U.S. credit rating had just been downgraded by Standard & Poor's and Europe was at the height of its fiscal crisis. Although many investors thought that another recession was the most likely scenario, this was not in the cards. In fact, the inflationary pressures caused by the last round of quantitative easing were just rolling off, and this set the stage for the upturn in leading indicators and the business cycle which began a few months later.



Leading indicators and equities were already bottoming when the Fed promised ZIRP through mid-2013.

Despite broad-based improvement in the economic backdrop, most investors wrote off the equity market rally as a temporary blip. Sentiment was extremely bearish, and since the Fed had guaranteed ultra-low rates for the next 18 months there was no risk of interest rates rising. Investors continued to park capital in Treasurys despite the strength in equities. In a sense the Fed's verbal commitment to ZIRP became another method of policy easing, albeit easing at a time when the business cycle was already heading into an upturn.

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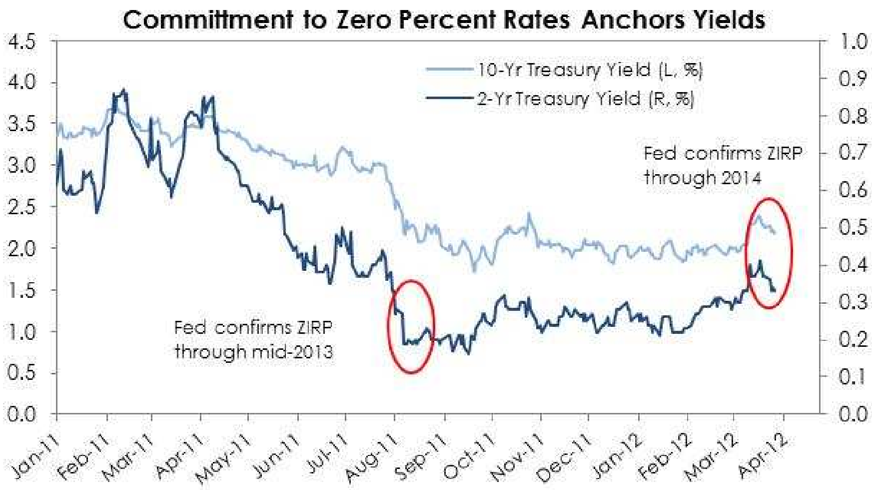
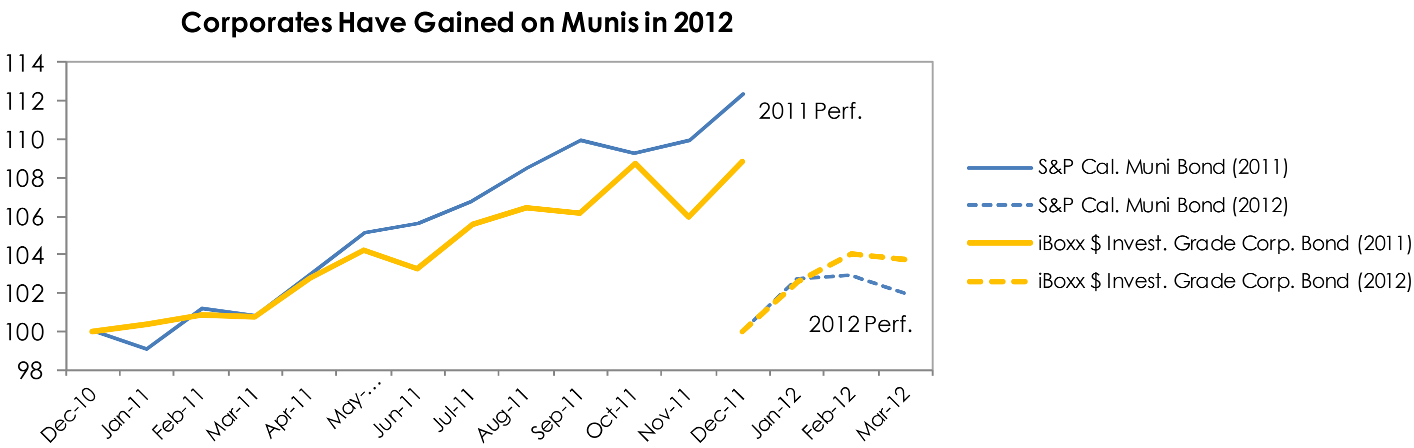


Several months of gains in equities and steadily improving economic data boosted bullish sentiment as more investors bought into the cyclical improvement story. Stocks began to present an increasingly-favorable risk/reward tradeoff relative to bonds, and yields started to back up in mid-March as questions arose about whether the Fed would maintain ZIRP despite its promise in August. Then on March 26 Chairman Bernanke confirmed his support for a **zero interest rate policy until the end of 2014** and yields fell.



Our view is that the Fed now is backed into a corner. Policy makers are unable to retreat from their commitment to zero rates without devaluing their only currency: credibility. Unfortunately, anchored interest rates have not and will not spark growth. Without an imminent threat of higher rates there is no urgency for consumers to purchase homes or cars. If a product is on sale for the next 18 months, will anyone run out to buy it tomorrow? On the other hand, these low rates will eventually contribute to inflationary pressures. **As investors, our main concern is where we can find sufficient yield without taking on too much risk.** Municipal bonds have been our primary fixed income allocation for clients – and also the best performing asset class in 2011 – but finding yield means extending our bond holdings out to longer maturities. This implies significant interest rate risk since higher yields can only be found well beyond the Fed's 2014 low-rate guarantee. Instead, we are shifting a portion of our municipal bond allocations toward corporate bonds. Companies are healthy, and we expect earnings to pick up in the next quarter to extend the equity rally. When the Fed does lift ZIRP, or inflationary pressures drive interest rates up organically, this will provide an opportunity for us to move back toward muni bonds and lock in higher yields. In the meantime, corporate bonds provide higher yields and potential for capital appreciation.

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