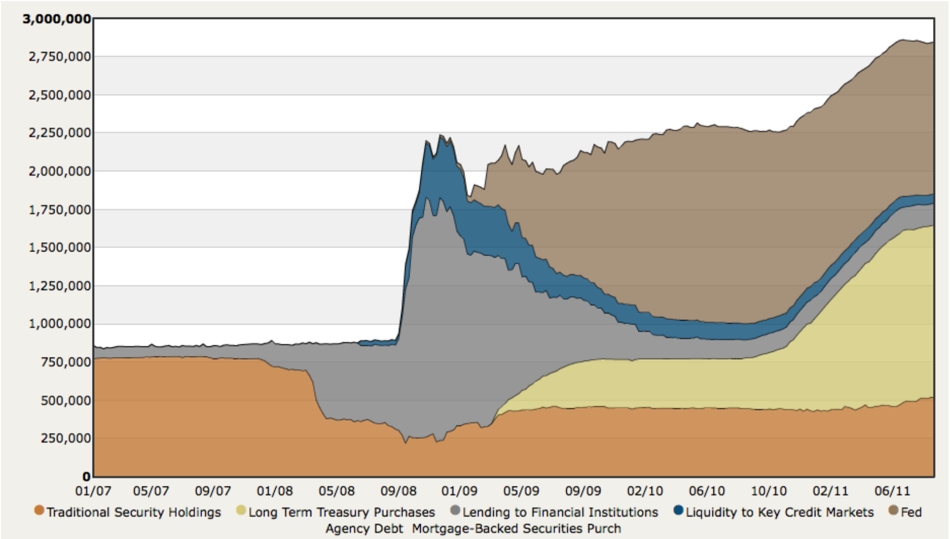
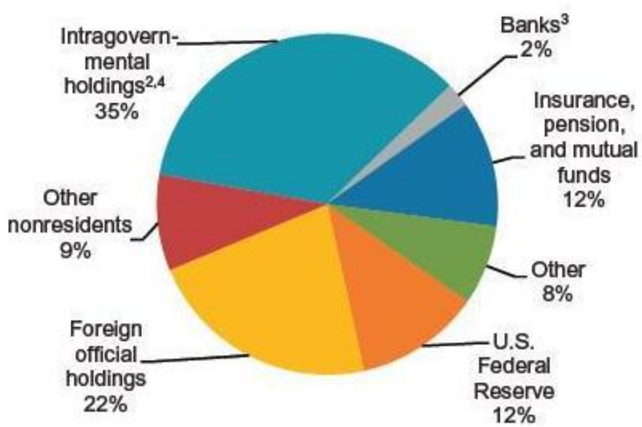
Market Recap

Federal Reserve Balance Sheet Assets



Source: Federal Reserve Bank

Holders of U.S. Treasury Securities



Source: International Monetary Fund

On Wednesday, the Federal Reserve announced 'Operation Twist,' a stimulus policy originated during the 1960s. The policy involves selling $400 billion in short-term Treasuries in exchange for the same amount of longer-term bonds between October and June 2012. The policy is designed to lower yields on long-term bonds, while keeping short-term rates unchanged. The intent is to push down interest rates, providing additional incentive to borrow and spend. Operation Twist will decrease the value of Federal Reserve holdings in traditional securities (orange bar) and increase the value of holdings in long-term Treasuries (yellow) and mortgage-backed securities (brown) to unprecedented levels. Based on the limited impact of QE2 and the modest size of Operation Twist, the new policy is not expected to dramatically increase GDP or jobs.

With all of the focus on the composition of Federal Reserve assets, we thought that it was interesting to run across this data released by the International Monetary Fund. Almost half (47%) of the $14.7 trillion U.S. federal government debt is held by the Federal Reserve and the government itself (e.g., Social Security trust fund). An additional 22% consists of foreign official holdings (central banks). In total, almost 70% of Treasury debt is held by non-market/non-profit oriented investors. Only a small fraction of the debt actually trades hands making the recent volatility of the Treasury market all the more alarming.

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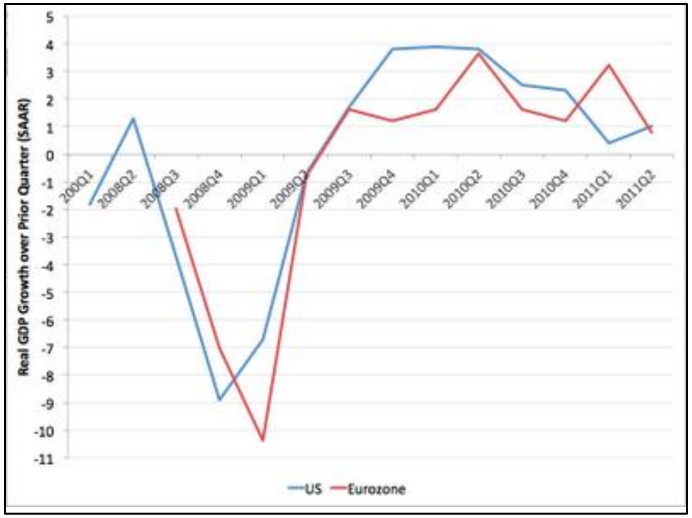
U.S. vs. Eurozone GDP Growth



Source: Thompson Reuters

Non-Financial Corporate Liquid Assets ($Billion)

Source: Northern Trust

The greatest risk to the markets is the current global slowdown. The graph shows both US and Eurozone GDP since 2008. Both economies are influenced by the same set of global factors. However, the Eurozone GDP lag going into the most recent recession was attributed in large part to the mortgage crisis originating here in the U.S. The economy in the U.S. recovered more strongly in late 2009 and early 2010 but has experienced a more patently obvious slowdown since. Meanwhile, the Eurozone recovery has been more volatile. Europe has not experienced a significant slowdown until this year. Many see a possible divergence, with a dramatic slowdown - or even contraction - in the Eurozone economy but a mere modest slowdown of growth in the U.S.

One of the best indicators of business sentiment is the level of liquidity maintained. Cash and other liquid assets held by nonfinancial companies have reached unprecedented levels of ~$2 trillion. This equates to 8% of their total assets, the highest ratio since 1959. Companies are stockpiling cash with a wait-and-see attitude toward the strength of the economy and as a buffer against potential future disruption to the financial system that might hinder their ability to borrow. When businesses regain confidence in the stability of the financial system and the sustainability of the recovery, they will begin to deploy these resources to buy new equipment and expand payrolls. It is clear that we are not there today.

Contact: If you have any questions or comments, please do not hesitate to contact us at 703.992.6164. For more information about Harbour Capital Advisors, please visit our website at www.harbourcapitaladvisors.com.

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