

November 2010

## Portfolio Commentary

By Jill King, Vice President, Senior Portfolio Manager

The US economy has begun to show signs of new life. Although, the November employment report disappointed with non-farm payrolls reporting a meager +39,000 new jobs and the unemployment rate increased from 9.6% to 9.8%. The disappointing report can be attributed to seasonal hiring effects and is not a harbinger of a slow down in the economy. In fact, the economy has shown signs of resurgence with the holiday shopping season getting off to a solid start. The improved outlook for consumer spending has led to a relatively optimistic US growth outlook. Couple this with the early holiday gift received from the president in the form of a compromise on extending the Bush era tax cuts and extending unemployment benefits. Disposable income and consumption spending during the first half of 2011 should be strong thus increasing many economist's forecasts for 1st Quarter 2011 GDP from 3.0% to 3.5%.

The cost of the tax cuts and unemployment benefits is estimated to be \$858 billion, over a 10-year time horizon. This will push the budget deficit to another all-time high necessitating an increase in Treasury issuance, which somewhat negates the effect of QE2. The abundance of Treasuries available will not only increase the interest rate paid on T-bills but will also increase the rate paid on repo.

The Federal Reserve's statement after their December 14th meeting, revealed nothing new. They continue to assert that rates will remain low for an "extended period". Pundits believe that the Fed will be on hold through 2011, but the necessity for additional quantitative easing, beyond what they announced in November, appears unlikely. In fact, some players suggest that the Fed does not complete the \$600 billion of QE previously announced.

The economy and the market have entered a transitional phase as we recover from the deepest economic downturn since the great depression. The Fed may not formally raise their interest rate target during 2011, but the market is agile and has already begun to price in the change in outlook for interest rates.

Players in the short term market continue to search for products that provide attractive yield without adding additional risk. We have witnessed a resurgence of activity and interest in the Yankee CD market with many foreign banks taking advantage of investors desire to find products that provide alpha. We have selectively bought attractive CDs in this sector.

We have also observed an improvement in the interest rate paid on US Agency securities. We have purchased a small amount of longer-dated callable agencies to provide yield enhancement for many client portfolios.

As we approach the end of 2010, we can look forward to a new year that is bound to present new challenges as we approach the end of the "extended period" of interminably low interest rates.

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