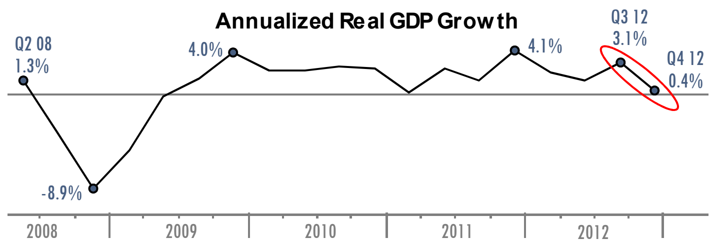
Your Quarterly Update on the Financial Markets
March 31, 2013

1st Quarter

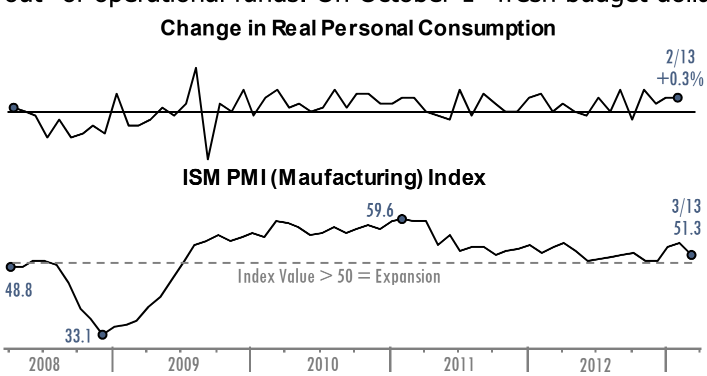
MARKET Recap

The Economy: *"Butter over Guns"*

The pace of economic growth fell sharply for the fourth quarter, after a reportedly robust Q3. Upon closer examination, neither quarter appears representative of the health of the economy, due largely to distortions in defense spending. Defense contributed -1.28% to the annualized Q4 growth rate and +0.64% to the Q3 rate. Rather, the full-year rate of 2.2% appears to more accurately reflect the current pace of growth. It's right in the "lackluster" range which foots to current Fed policy.

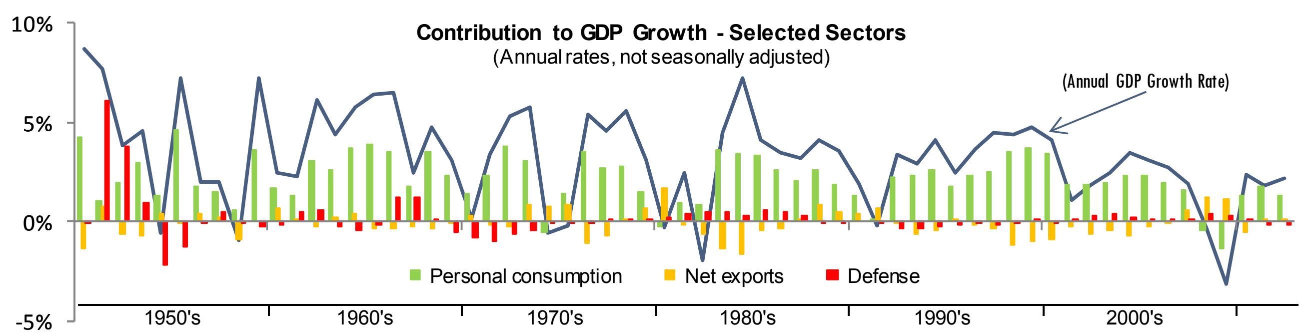


This gyration in quarterly GDP growth illustrates the risks involved in interpreting incremental data points. Military spending is in fact seasonal, driven not by weather, but by the peculiarity of the federal budgeting process. Spending normally slows in the quarter ending September 30th (the end of the federal fiscal year) as projects are delayed to avoid "running out" of operational funds. On October 1st fresh budget dollars appear, and spending accelerates to take up the slack. The Monthly Treasury Statement shows that, over the past 15 years, the average gain in Q4 defense spending has been 7.8%; for 2006-2010 it ranged from 8.6% to 23.7%.



2012 was different, as defense spending growth accelerated in Q3 and flattened in Q4. Economists apply seasonal adjustment factors in order to smooth out quarterly and monthly data. When a long-term seasonal trend suddenly changes, adjustment factors can temporarily magnify a distortion – in this case making Q3 look more robust than it really was, and Q4 more subdued. Why was defense spending accelerated in Q3? Conspiracy theories abound! Those from the left, represented by staff postings to the White House blog, suggest that uncertainty over the impending sequestration deadlines was to blame. Those from the right, such as Congressman Brady of Texas, suggest that spending was accelerated to inflate reported growth prior to the election. We invite readers to pick whichever conspiracy theory you like best or, like us, reject them both – noting that a similar effect occurred in 2011, with no sequestration or presidential election. The most likely explanations are coincidence, or an actual change in operational spending patterns.

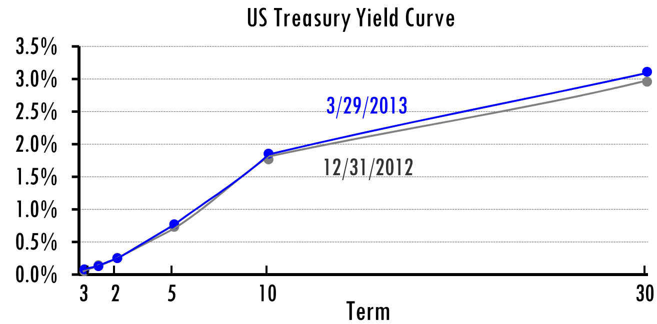
A more interesting question is the extent to which future reductions in military spending may affect growth, particularly since a decline in real defense spending has already begun. Long-term data surprised us a bit. Although defense outlays are immense, the impact of changes in defense outlays on growth has been surprisingly small. Not since the Korean War have changes in defense outlays dominated economic growth – including the buildup for the Vietnam War and the "Peace



Dividend" reductions of the Clinton era. Consumption has driven growth, tempered by declining net exports as goods and services are increasingly sourced from overseas. Ignoring the defense spending distortion, the same story played out broadly last quarter. Personal consumption expenditures increased by 0.3% in February, and early indications from the manufacturing sector show weakness, with the March PMI index surrendering gains realized in January and February.

The US Bond Market

While returns for intermediate-term US bonds were flat for the first quarter, longer-dated debt moved solidly into negative territory leading many to wonder if the long-anticipated dawn of a new era in bonds had finally arrived. Yields on intermediate and longer-dated treasuries moved higher during the first two months of the year only to pull back by the end of March as the Cyprus crisis fueled tension in the Eurozone. The yield on the 10-year treasury closed the quarter at 1.85%, up a mere 9 basis points from the end of 2012 and up almost 50 basis points from its all-time low of 1.38% posted in July, 2012. By the end of March the yield curve had steepened ever so slightly, with the spread between the 2-year and 10-year notes widening to 161 basis points from 150 basis points at year-end (almost back to its 2011 close of 165 basis points). Even the Barclays Aggregate wasn't spared.



Source: Bloomberg LP

With continued suppressed yields, investors looked to the high-yield market once again in the first quarter, making it the best-performing bond sector with a return of 2.9%. New junk issues totaled $90 billion for the quarter, on par with issuance in Q1 2012 (a year that saw record full-year issuance of $326 billion). Despite this, market demand outpaced the available supply, pushing yields to record lows. The yield-to-worst on the Barclays US High Yield index hit 5.56% on March 12 surpassing the previous low of 5.61% set on January 24. After record issuance in 2012, analysts expect lower volumes in 2013 since so many issuers have already taken advantage of the favorable market conditions. (In contrast, investment grade corporate bond issuance totaled just over $235 billion for the quarter according to JP Morgan, with 44% of corporate primary market activity in financial firms and a sector return of -0.1% for the quarter.) Emerging markets debt, a sector that has been targeted as an alternative to lower-yielding developed markets investment, was the worst-performing sector in 1Q 2013, with a return of -1.5%. Fears that some developing countries may not be able to absorb a huge influx of money without suffering an investment bubble have been voiced by some analysts lately, and at least in Q1, the market seemed to lend credence to those concerns.

Bond Indices - Total Returns

	1Q13
BarCap Aggregate	-0.12%
BarCap Interm. Gov't	0.14%
BarCap Long Gov't	-2.26%
BarCap Interm. Credit	0.47%
BarCap Long Credit	-1.79%
BarCap High Yield	2.89%

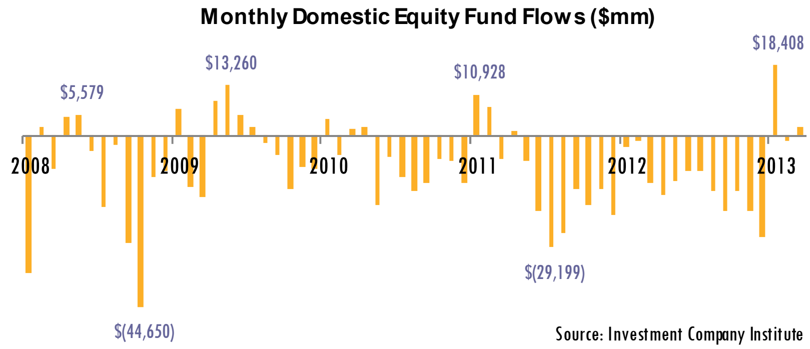
At the end of the quarter, the Wall Street Journal reported that many hedge funds that have specialized in bonds are increasing their focus on equities, another indicator that the bull market in bonds may be coming to a close. Along the same line, 309 bond mutual funds owned stocks at year-end, according to Morningstar, the highest number in a decade. With rates stuck at historical lows and spreads relatively narrow, investors seem to be shifting focus from credit-risk plays to protecting against interest-rate risk.

On a brighter note, more evidence of a US housing recovery presented itself with Fannie Mae's report that strong Q4 earnings allowed it to pay down some of its taxpayer bailout without additional borrowing from the government. This led to speculation that improving conditions could bring back competition to the mortgage securitization market. For the past several years, Fannie Mae and Freddie Mac have dominated that market with the Fed spending billions every month to buy agency mortgage-backed securities. In March, regulators proposed a new joint infrastructure for the two agencies, presumably to capture back-office efficiencies. However, even with the improvement in Fannie and Freddie's numbers, a return to competition in mortgage securitization seems unlikely, given the regulatory requirements under Dodd-Frank.

The US Stock Market

US equity markets reached record highs in the first quarter, continuing their upward trend from 2012. This was in spite of slow economic growth and the failure of elected officials to produce a comprehensive, bi-partisan plan to address major budget issues. On March 28, the S&P 500 closed 4 points above the October 2007 record index level of 1,565. Since 2008, domestic equity funds have had net outflows each year totaling almost $550 billion as investors have piled into bond and global equity funds (positive flows each year since 2009). January was the first month of positive flows for US equity funds since April 2011 and the highest in 5 years. Total Q1 net inflows were an estimated $19.5 billion with the majority moving in January, more specifically the week after the fiscal cliff was avoided (Investment Company Institute).

Midcap stocks outperformed during the first quarter of 2013, with smallcap and largecap stocks trailing closely, similar to 2012. Also, value largely outperformed growth in both the large- and mid-market capitalization segments, however the opposite was true for smallcap stocks. Of the companies included in the S&P 500 index, 69% reported earnings above analyst expectations for Q4 2012 compared to the historical average of 62% and the average of the previous four quarters of 65%. Also, 64% of the companies beat revenue expectations (Thompson Reuters). In 2012, dividends paid out from companies in the S&P 500 totaled $310.5 billion, a 10-year high for trailing 12-month periods, and the number of dividend paying companies increased to a 13-year high of 405 (Factset).



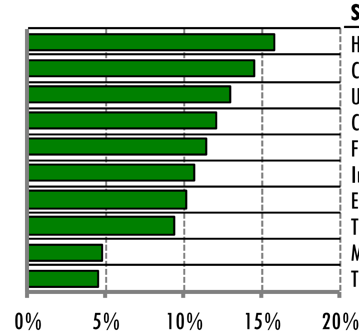
Stock Indices - Total Returns

Largecap Stocks	1Q13	Midcap Stocks	1Q13
S&P 500	10.61%	S&P Midcap 400	13.45%
Russell 1000	10.96%	Russell Midcap	12.96%
Growth	9.54%	Growth	11.51%
Value	12.31%	Value	14.21%
Broad Markets		**Smallcap Stocks**	
Russell 3000	11.07%	S&P Smallcap 600	11.81%
Growth	9.82%	Russell 2000	12.39%
Value	12.26%	Growth	13.21%
		Value	11.63%

Health care and consumer staples, both average performers during 2012, led the S&P 500 higher while technology and materials, also average performers for 2012, were the biggest laggards. Performance in the health care sector remained unaffected by the uncertainty surrounding the Affordable Care Act, and benefitted from biotechnology, the best-performing industry of the S&P 500 for the quarter. The consumer staples sector outperformed as 74% of its constituents beat earnings expectations, above the index average of 69%, and alcoholic beverage companies posted strong gains. Technology stocks actually performed well overall. In fact, the sector had 83% of its constituents beat estimated earnings, and companies like Blackberry and HP made significant turnarounds from 2012. However, the sector underperformed due to the drop in Apple's stock price. Apple, which currently represents about 18% of the entire sector index, fell 16% during the period. The materials sector lagged the broader index as the metals and mining industry lost over 6%, largely due to major constituent Cliffs Natural Resources plunging over 50% (the worst performing S&P 500 company).

With record-high US equity index levels, the question on any investor's mind right now is, "Where do we go from here?" Outside of the nascent housing recovery, domestic economic indicators have only been marginally positive and equity valuations continue to push above historical averages and medians, all while equity markets climb upward. But does this mean we are due for a large market correction? In 2012 the S&P 500 dipped twice, from April 2 to June 1 and September 14 to November 15 with drops of 9.9% and 7.7% respectively, indicating a large correction might not be as close as some think. Additionally, the fear of future rising interest rates will likely drive investment flows out of bond funds and into equity funds, either reducing the severity of such a correction or even pushing levels higher. What could be a significant factor contributing to an equity market correction, likely through a larger, broad market downturn, is an unanticipated decrease or end to the Federal Reserve's continuing bond purchases.

S&P 500 Economic Group Components - Total Return



Sector	1Q2013
Health Care	15.81%
Consumer Staples	14.58%
Utilities	13.02%
Consumer Discretionary	12.15%
Financials	11.42%
Industrials	10.67%
Energy	10.17%
Telecom	9.45%
Materials	4.79%
Technology	4.59%

Source: Standard & Poor's

Overseas Markets

Global equity markets started the year much as they ended 2012, with developed markets turning in solid positive performance. Investors continued to watch the European crisis with a wary eye as another peripheral threatened to set off a global panic. In the Far East, a cooling China and concerns over real estate financing and potential property "bubbles" was also a cause for concern. Emerging markets, again, trailed their developed peers.

The Eurozone seemed unable to extricate itself from the grips of overextended sovereigns. While "no news was good news" from the PIIGS, tiny little Cyprus poked its head up and threatened to become the next in a series of dominoes to fall. Cyprus began using the euro in 2008, expanding its banking system to many times the size of its GDP over the past few years. Strict banking secrecy and lax taxation rules led to an inflow of capital, mostly from Russia, as the oligarchs moved significant amounts of money to Cypriot banks to avoid seizure of assets in their home country. The banks invested nearly $5.3 billion (about one-third of Cyprus' GDP) in Greek bonds which, when they fell to junk status brought the

Foreign Stock & Bond Indices - Total Returns

MSCI Broad Indices	1Q13	Barcap Global Indices*	1Q13
World Index	7.73%	Global Aggregate	-2.10%
EAFE (Developed)	5.13%	Pan-Euro	-2.79%
Emerging Markets	-1.62%	Asian-Pacific	-5.11%
		Eurodollar	0.76%
MSCI Regions		Euro-Yen	-6.58%
Europe	2.71%	Other Currencies	2.20%
Japan	11.63%	*Unhedged	
Pacific ex-Japan	7.02%		
Latin America	0.89%		

Cypriot banking system to its knees. The European Commission, ECB and IMF put together a €10 billion bailout plan which would have imposed a levy on all depositors, mostly as an attempt to punish large depositors who may have been engaged in tax evasion or other illegal activities. However, the levy would have also impacted ordinary Cypriots, and the idea was met with a public outcry. It also undermined confidence in the Cypriot banking system, resulting in a run on the banks which was halted with the imposition of a bank holiday. Capital controls were also implemented to keep euros "in country" with the implication that a euro held in a Cypriot account can't be moved, withdrawn or even spent the same as a euro held elsewhere in the Eurozone. Said differently, a Cypriot euro is worth less than a non-Cypriot euro. It is clear that the entire process was seriously mismanaged as, in addition to needed austerity, a penalty on depositors was imposed for the first time in a bailout. This represents a departure from previous bailouts of other Eurozone countries as pains have been taken to protect the solvency of European banks without impacting depositors. Ultimately Eurozone finance ministers came back with a revised proposal; only large depositors, those with more than €100,000, would have to take a loss. The larger implication is that the next time flags go up in Spain or Italy their banks are more likely to face a bank run scenario, as depositors can no longer trust in their deposit insurance. A run on banks in these countries could easily become a world-wide panic.

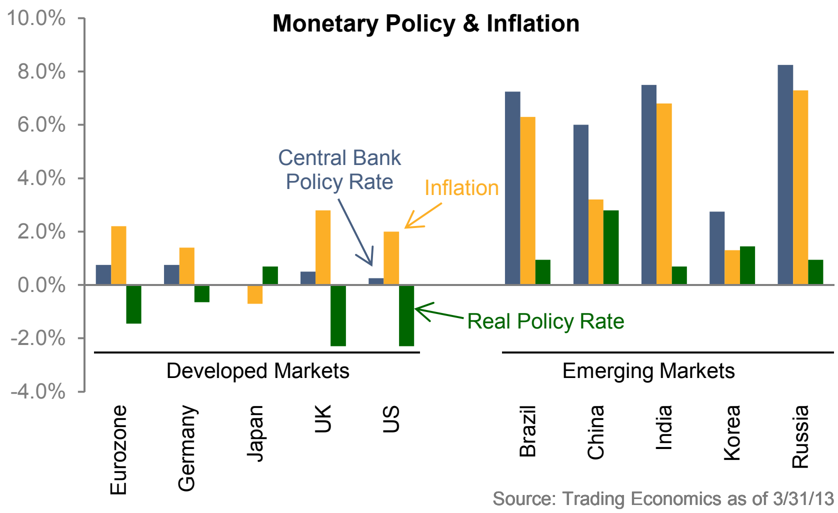
Elsewhere in Europe, solid market performance belied an undercurrent of worry. Favorable economic data, including the smallest contraction in Markit's Eurozone composite PMI in 10 months, helped steady markets, but the euro remained vulnerable to a volatile political environment. In Italy, the government of Prime Minister Mario Monti came under attack for its decision to bail out a bank in Siena that may have hidden losses in derivatives contracts, and former Prime Minister Berlusconi used the scandal to bolster his election campaign. As the quarter closed, consumers and businesses around the Eurozone appeared to be feeling gloomier about their prospects. The headline Economic Sentiment Indicator (ESI) that aggregates surveys of businesses and consumers across the zone fell to 90.0 from 91.1, the first decline since October of 2012. The drop in the ESI was larger than expected, with economists expecting a fall to 90.5. It is also notable that the survey was completed before the Cyprus bailout that raised doubts about the safety of large deposits and pushed up borrowing costs for a number of governments. Confidence among all types of businesses weakened. The measure for manufacturing companies fell to -12.5 from -11.3 as new orders, including export orders, dropped. For service providers, retailers and construction companies, the measures also fell. Consumer confidence weakened less dramatically, with the measure falling to -23.5 from -23.6. Consumers were more pessimistic about the outlook for the Eurozone economy, but less fearful of losing their jobs.

Foreign holdings of Japanese equities increased by $21 billion in the last six weeks of 2012. The increase reflected faith in Prime Minister Abe to increase growth through an additional $120 billion of new public spending to create inflation and reduce Japan's debt-to-GDP ratio. This goal will be difficult to attain as Japan's once-robust economic growth has been anemic at best, averaging less than 1% per year. Government spending to stimulate economic activity has outstripped tax revenues, resulting in a sharp increase in government debt. Japanese government gross debt is now around 240% of GDP and total gross debt (government, non-financial corporation and consumer) exceeds 450% of GDP. Japan's massive savings, low interest rates and large current account surplus has allowed the buildup of government bonds, about 90% of which are held domestically. Continued low interest rates have made servicing the high levels of debt manageable. However, if Japan continues to run large budget deficits, as is likely, then a declining savings rate and reversal in its current account will make it more difficult for the government to borrow, at least at current low rates. Cutting the budget deficit will be difficult as social security and interest expense has become a greater portion of government spending.

China's economy grew by 7.9% in the fourth quarter compared to a year earlier, beating economists' expectations and signaling an improving trajectory. The GDP growth represented an increase from 7.4% in the third quarter and 7.6% growth in the second quarter (the Chinese government targets 7.5% annual GDP growth). Annual GDP growth for 2012 was 7.7%, down from 9.3% in 2011. Other December data presented a similar picture. Industrial output in December rose 10.3% from a year earlier, in line with economists' expectations and higher than the 10.1% increase in November. However, midway through the first quarter there were signs of moderating growth, and word came that China might hold off tightening monetary policy after growth in services and manufacturing weakened. Expansion in industries including retailing, transportation and banking was the slowest in five months in February, according to an official survey of purchasing managers. Early indications from March showed manufacturing growth cooling as well.

Mortgage rates in Hong Kong increased for the first time in 18 months as concerns over a property bubble have grown. The increase is the first since September 2011 and is expected to increase rates by about 30 basis points. The potential for a property bubble on the Chinese mainland continued as financing through high-yield bond issuance has caused concerns. According to a report in the New York Times (March 28, 2013) about half of the high-yield issues in Asia last year came from Chinese Real Estate companies. Worries have arisen around whether investors are being fairly compensated for risk as yields on high-yield debt issues have fallen in China (and abroad), and the ability of issuers to service debt should there be a housing downturn on the mainland.

South Korea announced it will unveil a stimulus package in April to spur the property market and revive the economy after cutting its growth forecast for the second time in four months. According to the central bank, the economy is expected to expand 2.3% this year, down from a 3% forecast in December. The new forecast is more pessimistic than the central bank's outlook for 2.8% growth and has led to concern that expansion in Asia's fourth-largest economy will stall after slowing to the weakest in three years. With the specter of a stagnant property market and weaker yen, the Bank of Korea may come under pressure to lower its benchmark interest rate in April as well.



Source: Trading Economics as of 3/31/13

Brazil's central bank policy stance showed a change and opened the door to possible interest rate increases from a record-low level. At the end of March, the central bank left the Selic rate at 7.25%, the level that it has been at since October 2012 after falling from a high of 12.5% in July 2011. The rate setting committee of the bank chose to remove language about keeping rates low for a "sufficiently long period of time," setting the table for a possible rate increase at the next meeting in April. The potential for a rate hike comes as inflation in Latin America's largest economy has been on the rise. Inflation as measured by the benchmark IPCA index reached 6.15% in January, moving closer to the upper level of the bank's inflation target of 4.5% (plus or minus two percentage points).

In contrast, the head of Colombia's Central Bank, Jose Uribe, said the bank planned to buy at least $30 million daily in the foreign exchange market to tame the peso. This came after the bank's January meeting, where the seven-member board voted to cut interest rates 25 basis points to 4%. It was the third straight month of cuts aimed at spurring an economy that grew less than 4% in 2012 after a nearly 6% expansion in 2011. Slower growth is reflected in sluggish consumer activity and a contraction in industrial sector output. Mr. Uribe expects the bank's reduction in interest rates to be passed along by private banks to companies and consumers "to make credit cheaper and stimulate spending and investment." In addition to the rate cut, the bank hopes to mop up excess dollars and weaken the peso with its foreign exchange purchases. Colombia's peso is 9% stronger versus the dollar over the last year. The peso's relative strength against the dollar has made Colombian exports, everything from coffee and bananas to manufactured goods,much more expensive in global markets. Mr. Uribe didn't give a target rate for the peso; however, Finance Minister Mauricio Cardenas, who is also a member of the central bank board, said the peso should be about 10% weaker from its current level.

Focus On: *Leverage, Leverage (Almost) Everywhere*

In January 2007, we explored the prevalence of leverage throughout the economy in a piece entitled "Leverage, Leverage Everywhere." The concluding paragraph included this warning:

> *The linking of risk between the consumer, corporate and investment sectors should be closely watched. Falling housing prices could render homeowners' debts larger than their home values, which could have an adverse impact on their ability to make purchases. Since consumer purchases have been such a large part of GDP, less consumption would lead to lower corporate profits. In the case of companies that have increased debt financing, lower profits have the potential to make their debt service difficult. Investors should also be wary of the trend of increasing debt in hedge funds...*

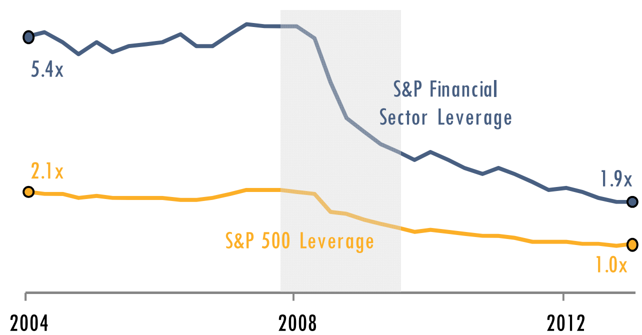
Of course that very scenario played out, and global economies are still struggling to deal with the aftermath. The proposed remedy is the hair of the dog, a restoration of leverage to reflate equity markets and promote economic activity. Now six years into the process, we pause to re-examine leverage throughout the economic system.

Leverage, an iteration of debt, comes in many forms within our economy. The stage is filled with four actors, all with immense impact on economic activity – (1) the consumer, (2) the corporation, (3) the government and (4) the investor. When levels of debt are expanding, it typically translates to near-term increases in GDP. "I will gladly pay you Tuesday for a hamburger today," promises Wimpy in the iconic Popeye cartoon; this famous line illustrates the US cultural approach to debt. Leverage is a tool that allows market participants to engage in spending and investment when benefits, either economic or intangible utility, outweigh costs.

The Great Deleveraging

Much has been said about the deleveraging of Corporate America and, in fact, the sector has significantly de-levered. That has particularly been the case for banks and other financial companies, where leverage plummeted during the credit crisis. Consequently, the balance sheet of American corporations are generally more sound than they have been in two decades.

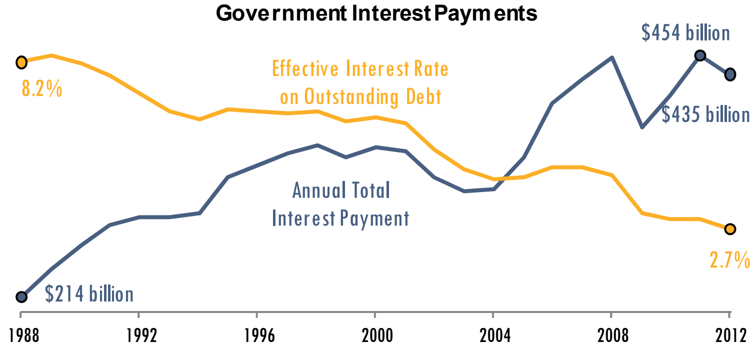
Corporate Leverage (Total Debt/Total Equity)



Corporations opportunistically vary their capital structures based on costs, sales forecasts and bottom line profits. When the cost of debt conveyed through interest rates is high, corporations tend to prefer raising capital through equity offerings. If interest rates are low, companies turn to debt markets to raise capital. According to data provided by the Securities Industry and Financial Markets Association, US corporate debt has increased 8.2% on an annualized basis from 2002 – 2012 and never had a declining year since 1980. Moreover, debt issuance grew 34.7% over the past year, to a record of $1.35 trillion. While debt outstanding has increased, corporate leverage in the S&P 500 and financial sector illustrates a different trend, both contracting significantly since early 2008. Being acutely aware of the banking sector deleveraging effect, the Fed is creating $85 billion per month in new money ($1.02 trillion per year) in an effort to offset the negative impact of bank balance sheet contraction.

Possibly the greatest beneficiary from the current economic environment of cheap money, corporations have benefited doubly from low cost of capital and the resulting economic expansion. Additionally, slack in the labor market has also led to an inexpensive workforce, driving record earnings for many companies over the recent past. However, the Fed's actions do have unintended consequences. Loans that would typically default and clear the market during a contraction are being helped by cheap money and low rates. When good times come to an end and the Fed enacts tighter policy, these weaker loans will be the first to once again stress banks' balance sheets, leading to the need of even more unprecedented monetary policy actions.

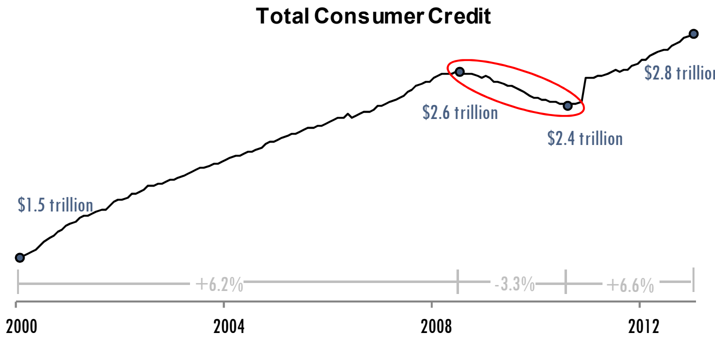
Government Interest Payments



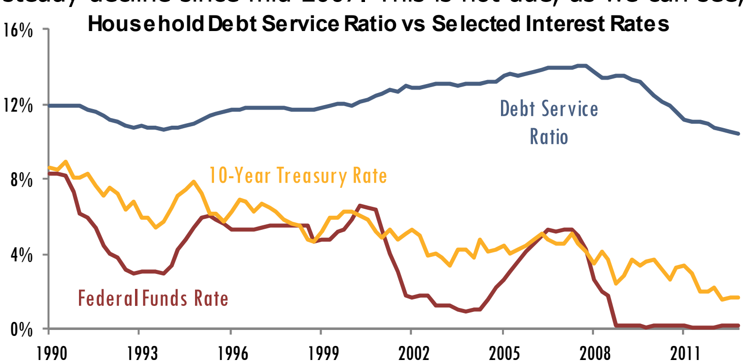
But has corporate deleveraging changed the overall picture? Largely no, as the equity created to de-lever the banks has been supplied by the government, swapping private debt for public debt. Government debt has been a focal point of financials markets, as issues in the Eurozone illustrate the challenge nations with overleveraged balanced sheets face. Debt ceiling debates, fiscal cliff negotiations and more generally US government budget sustainability concerns have caused periods of increased market volatility around future policy uncertainty. As government debt becomes a larger portion of overall leverage within the economy, it will continue to be a dominating factor for future market performance. After adding back a one-time negative adjustment of $75 billion in 2012 due to a change in the accounting method for the Department of Defense market-based securities, the government paid $435 billion to service its outstanding debt of $16.1 trillion, at an effective rate of 2.7%. The trend in the federal government's effective interest rate on outstanding debt has been on a favorable and in consistent decline since the late 1980s.

The Great Releveraging

What about leverage in the rest of the economy? It's a basic tenet of economics that, when you reduce the price of something, you increase the quantity demanded. One would expect that record-low interest rates would lead to an expansion of debt outstanding. At the consumer level, that has clearly been the case. The aftermath of the financial crisis caused a clear contraction in total consumer debt from 2008 – 2010. The Federal Reserve often cited the trend as a significant concern and eventual justification for unprecedented monetary policy measures – QE1, QE2, Operation Twist and QE3. The consumer responded to low rates and loose money by reflating their balance sheets, beginning in late 2010 and continuing to the present day. Much of the reduction in leverage generated through mortgage defaults and restructurings have been replaced by increased non-revolving loans, including car loans and other consumer finance vehicles. Furthermore, the steepness of the increase over the latter period is +6.6%, compared with +6.2% for pre-financial crisis levels. In a world where debt is financed with higher levels of debt, policymakers are achieving their reflationary goal.



Household debt service ratios provide an interesting story on the consumer's ability to meet loan interest payments. Defined as the ratio of debt payments (mortgage and consumer) to disposable income, the debt service ratio has been on a steady decline since mid-2007. This is not due, as we can see, to lower debt levels; neither is it due to rising income levels. Rather, it is primarily a function of lower rates. The end result: the consumer is using less disposable income than at any time in the last two decades to make interest payments on loans, because loans are very cheap. An object of rate cuts has been to spur economic activity by making the consumer feel wealthier. Yet, in the face of higher consumer debt levels, their ability to service debt is largely contingent on rates remaining low. Unlike mortgage rates, which are relatively sticky as general interest rates rise, rates for credit cards and shorter-duration non-revolving consumer loans can rise quickly.



Leverage within investment assets is dominated by hedge funds, which have been gathering considerable amounts over the past two decades. Hedge fund assets stood at $200 billion in 1998, grew to just over $1 trillion in 2006, and stand at $2.6 trillion as of 2012. Considerable interest among institutional investors has been the underpinning of robust industry growth, but returns during and after the credit crisis have disappointed investors. With fierce competition in the space, many funds are increasing leverage to generate greater excess returns. According to Morgan Stanley, gross leverage averaged 143% in 2011 and 152% in 2012, a bet that their strategies can withstand market corrections by superior positioning, nimble trading and uncorrelated risks. Financial market losses can force hedge funds to unwind leveraged positions, creating a cascading effect within the industry that could quickly work its way into the broader economy.

Implications

Cheap money is impacting all players in the economy – the consumer, corporation, government and investor, with debt levels increasing at similar, if not faster, rates than historical norms. But, leverage has its costs. While rates remain at historical lows, economic players are generally able to meet debt obligations. At the consumer level, using variable credit card rates for revolving credit (15.1%) and 30-year mortgage rates for non-revolving credit (3.6%), we arrive at a blended rate of 7.1%, equating to $199 billion of interest payments for 2012. Small increases in interest rates can have meaningful effects on consumer spending. For instance, a 1.0% rise would burden the consumer with an additional $27 billion of debt servicing payments. Likewise for the government, just at a magnified pace; a 1.0% climb in the government's effect interest rate would cause a $161 billion rise in its annual net interest expense.

Everyone, including the Federal Reserve, agrees that rates must eventually rise. The Fed has communicated two trigger criteria – unemployment dipping below 6.5% or inflation pushing above 2.5%. Debt servicing sensitivity varies depending on duration, but invariably, the long-run effect of interest rate hikes will be higher debt payments for all participants in the economy. With record levels of debt today, the current positive impact of consumer spending, corporate profits, and tax revenues on economic growth is likely to fade with even a small increase in interest rates. We remain concerned that using more leverage to reflate the economy sows the seeds of the next crisis, as it has done in the past. But at current levels of interest rates, the dog is nearly hairless, and the risk of permanent capital loss is elevated.

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