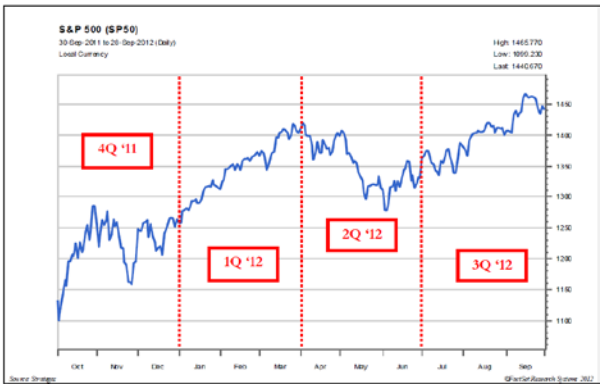
ECONOMIC & MARKET REVIEW

Third Quarter 2012

BOK FINANCIAL CORPORATION

The S&P 500 rose 6.4% in the third quarter of 2012 and the 10-year Treasury note yield dropped 2 basis points to end the quarter at 1.64%. The economic news in the U.S. was in the "muddle through" category with the most important improvement coming from housing. Housing was the epicenter of the 2008-2009 recession, but home prices have stabilized and are now showing modest improvement. Housing stands the chance of being an unexpected positive for the economy in 2013.



Source: Strategas Research Partners

The most important economic/market event was European Central Bank President Mario Draghi's statement that the ECB stands behind the euro: "To the extent that the size of these sovereign premia hamper the functioning of the monetary policy transmission channel, they come within our mandate," Draghi said in a speech at the Global Investment Conference in London. "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro," he said, adding: "**believe me, it will be enough**." This last statement indicated to everyone that the ECB is committed to the euro and would act to protect its viability by "doing whatever it takes to preserve the euro." That took the worst case outcome off the table, a complete and unmanaged dissolution of the euro where markets, not policy makers, drive outcomes. Clearly, simply saying something does not mean it will happen, but hearing his bold commitment has calmed markets. In the near term, Europe is still the most likely place for bad economic news to happen in the world. Riots and protests have reappeared in Spain. The Germans are reluctant to continue to open their checkbook without commitments of austerity from troubled countries, and those who are in tough shape are tired of Germany's constant demand for more austerity. Spain and Greece have unemployment rates that are near 25%. As a reference point, the only time the U.S. reached this level was during the Great Depression. This may be the reason the Germans report that through the first half of this year's Oktoberfest they are headed for a new beer-guzzling record after 3.6 million liters were downed in the first week alone.

Coming in a close second for the most important economic/market event was Federal Reserve Chairman Ben Bernanke's commitment to another round of bond buying (called quantitative easing or QE) to aid the growth of the U.S. economy. The core sentence from the Federal Reserve's September 2012 Open Market Committee statement: "a high accommodative stance of monetary policy will remain appropriate for a considerable time **after the economic recovery strengthens."** The highlighted portion at the end of the sentence was the most revealing. The Fed has clearly indicated they will continue to stimulate the economy even after a recovery is under way at the risk of potentially higher inflation. The Federal Reserve has a dual mandate to promote price stability and maximize employment. They have succeeded in keeping inflation under control (even below their two percent target now) but have been unable to move the unemployment rate down enough. They are now turning their attention to the employment mandate and will fade the inflation target if necessary. I am not sure if another round of quantitative easing will have any more of an impact on employment than the earlier rounds had.

I mentioned last quarter that the Chinese have been trying to slow the rate of growth of their economy. Gross Domestic Product (GDP) growth

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rates were as high as 12% in 2010, cooling to something around 7% in the second half of 2012. Many are worried that they may not be able to keep growth high enough and that the sharpness of the decline could mean growth slows way too much. The Chinese are capable of changing course quickly and moving to a very accommodative stance if necessary. If that were to occur they would find themselves aligned with most of the central banks around the globe in providing stimulus to their economies.

We are now just ninety days away from the fiscal cliff, a combination of spending cuts and tax hikes that are all set to happen automatically at year-end. If allowed to occur without alteration they would risk throwing the U.S. into a recession. Think Wile E. Coyote running over the edge of the cliff before he realizes there is only air under his feet. Changes to the fiscal cliff, to soften the impact, will have to happen somewhere between Election Day and the end of the year. The President and Congress haven't exactly earned a reputation for being able to find common ground on any topic, especially tax and spending policy. But, I am expecting an agreement to be reached this year. However, the deal would probably be short-term and not address the long-term debt and deficit issues that desperately need attention.

The U.S. economy is simply not growing fast enough to generate jobs or slowing enough to expect another recession. The Federal Reserve's quantitative easing (QE) experiment has so far not produced meaningful job growth or, for that matter, kept inflation at their 2% target. QE could have, as a by-product, the potential to ignite inflation, though so far there is no evidence of that… unless bond and stock prices are where the money printing is showing up.

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