

Special Market Commentary

August 6, 2011

The Herd Stampedes

As you know, stock markets around the globe sold off dramatically on Thursday. It was a classic case of panic selling, a “get me out” herd stampede that trampled not only stocks around the globe but gold, oil, industrial metals, anything perceived to be risky. The US stock market shed 5% of its value, which put the market down 12% from its recent high in April and down 3.5% so far in 2011.

With the market down more than 10% from its peak we are now officially in a market “correction.” So over this weekend investors are likely wondering: Is that all it is?

The Spark

While the causes of Thursday’s panic are complex, the proximate cause appears to have been the release Thursday by the European Central Bank (ECB) of its monthly policy statement—and specifically what it didn’t say. The ECB announced no policy changes, which was taken as a tacit refusal to come to the aid of the two largest struggling Eurozone countries, Spain and Italy.

Government debt issued by Spain and Italy has been sold down aggressively on fears of those nations’ potential default. As this debt is widely held as reserves by European commercial banks, those banks’ balance sheets are weakening as a result. This in turn crimps European banks’ ability both to lend money to businesses or individuals and to borrow money themselves from other banks. This is evident from the recent spike up in European interbank lending rates.

Fascinating as it is, one might ask why investors here should care so much about Eurozone interbank lending. The short answer is: Because it smells like the seizing up of the US financial system in 2008. We can call this fragrance “Eau de Lehman.”

Recall that in 2008 US banks’ balance sheets weakened as a result of falling prices both for real estate and for bonds backed by mortgages on that real estate. As those bonds’ value came under suspicion, the markets for them dried up and their prices fell. Ultimately no bank wanted to lend to any other for fear of drawing the “Old Maid,” as in the card game, that is, lending to a bank about to collapse from too much exposure to mortgage-backed bonds. When the Lehman Brothers investment bank collapsed for just this reason, the US financial system seized up and so began the Great Recession.

Long story short, the spark that started the stampede Thursday was a fear that the European financial system would seize up in a replay of the Lehman collapse.

If Europe seized up, it would hurt US exports, which have been a bright spot in the US economy. With the US economy growing at what is essentially “stall speed,” such a shock could push the US back into recession. So, take one potential credit crisis in Europe, add a return to recession in the US, and voila! A recipe for market panic.

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No Fun at the Tea Party

The bottom-line question in all this is: Will the US fall back into recession?

Last Thursday's market turmoil stirred European leaders to action. On Friday Italy announced its budget would be balanced a year earlier than expected, a gesture of appeasement to the ECB and its requirement that Eurozone countries tighten their belts if they want central bank help. The same day ECB President Jean-Claude Trichet indicated the ECB would support Italy's bonds. While the situation is evolving, European leaders clearly got the message and are working to ease concerns.

But the bigger problem, in our opinion, is the widespread and exclusive reliance on "belt-tightening" to solve the problems of sluggish economic growth. We believe governments throughout the developed world are making a major fiscal policy mistake by emphasizing budget deficits to the exclusion of **job** deficits.

As we recently saw in the ghoulish kabuki theater known as "The Debt Ceiling Debate," the federal government has now officially drunk from the Tea Party's pitcher. The entire debate focused on bringing down the budget deficit by reducing spending and/or raising taxes. There was no attention paid to creating jobs, no talk of stimulating the economy. And yet getting the US economy growing again would be the best way to bring down the budget deficit.

Adding insult to injury, the deficit reduction deal that was struck fell completely on the spending side with no new revenues as part of the deal. Much the same is happening throughout Europe and the UK. Austerity is the new religion.

What this means for the US economy is that US fiscal policy will now turn from a tailwind of stimulus (TARP, etc) to a headwind of spending cuts. And that does raise the odds of recession in the US. No doubt about it.

So while the ECB may have sparked Thursday's sell-off, we think the markets are also issuing a resounding vote of no confidence in the developed world's current political leadership. Standard & Poor's downgrade of long-term US debt to AA+ on Friday made it official.

A Self-Sealing Tire?

There is, however, a discernible silver lining to all this market and economic weakness, which is that oil prices have fallen sharply, closing at \$87 a barrel on Friday. As we explained in our July Commentary, the overall health of the US economy today is unusually dependent on the state of headline inflation (= food and fuel). As the US economy is driven by consumer spending, and since we're not adding jobs or increasing wages, overall US consumption is driven by how much we have to spend on things other than gas. When oil prices fall, we send fewer dollars overseas to oil producers and have more to spend on discretionary items here.

So the slowdown in the global economy has brought down fuel and food prices, which gives the US consumer more disposable income. This should lead to increased spending, which in turn should lift the US economy.

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If the US economy continues to expand, even sluggishly, the current market upheaval should remain just a correction. Remember, we went through this very same thing the same time last year: The stock market fell 16% from April to July, putting the market in the red by 8% at that point in 2010. But the market recovered and ended up with a gain of 15% for the year.

At current levels, the S&P 500 is up 80% from the low it made at the bottom of the bear market in March of 2009. S&P 500 earnings are up 128% in the same period. Which means that US stocks are cheaper today than they were at the very nadir of the last bear market. Short of the US slipping into recession, stock valuations today afford plenty of headroom for share prices.

What We're Doing

Given the increased risk of recession we have shifted our asset allocation policy from a neutral to a defensive posture that underweights equities and overweights bonds/cash. We are not selling stocks to achieve this posture. Falling stock prices and rising bond prices have effected this shift in portfolios. We're simply not yet buying stocks. This seems only prudent, given recent volatility.

This defensive posture does not reflect a conviction that recession is on the horizon. Indeed, we think the odds are good that falling headline inflation will spur consumption and thereby lift the overall economy and the stock market. But our first priority is always the preservation of your capital. Being defensively positioned in our portfolio strategy for now simply reflects our preference to have surprises be on the upside rather than the downside.

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