

Recent Thoughts
October 2011

Volatility returned to the stock market with a vengeance during the third quarter. A credit rating downgrade of U.S. debt by S&P, growing fears over a renewed slump in global growth, and concerns surrounding the debt situation in Europe were the driving forces during the quarter. Following a steep decline early in the quarter, the market staged a series of sharp moves, both higher and lower, as it attempted to find a bottom. In August and September, the Dow Jones Industrials experienced more 1% and 2% daily moves than any time since the nadir of the credit crisis in the spring of 2009.

As would be expected, investors favored defensive stocks during the quarter. Utilities were the only sector to generate positive returns. Energy, Industrials, Materials and Financials were all down over 20%, making them the worst performing sectors in the S&P 500.

All eyes were focused on Europe during the quarter and its attempts to stem any further escalation of its debt woes. The origin of the current episode, and the country most severely impacted, is Greece. Thus, most of the attention has been directed at dealing with Greece and quarantining the worst of the problems before they spread. The question is often asked why a country as seemingly inconsequential to the world economy as Greece has such an outsized impact on the global financial system. The answer lies in the vast interconnectedness of global finance and the tendency for a crisis that starts small and locally to spread through the global financial network and become a contagion. The sequence has a damaging impact on confidence and hinders the ability of the capital-allocating process to work freely. Capital, essentially, goes on strike.

In this case, the debt of Greece, which appears unable to pay its bills, is held by European banks. A default by Greece would harm those banks holding Greek bonds, leading to a decreased capacity to lend and, in the worst case scenario, the need for a bailout. Furthermore, investors have begun to speculate on which countries will follow in Greece's footsteps. Credit costs have risen for those countries deemed weakest (Italy, Spain, and Portugal) and they are slowly being squeezed from the capital markets. Lastly, the entire structure of the European economic system - under which each country conducts its own fiscal policy but is subjected to region-wide monetary policy - has been called into question. This has further shaken confidence. And during periods of turmoil, shaken confidence has a tendency to become contagious.

With the gravity of this situation in mind, it is obvious why global financial leaders have directed tremendous resources toward rectifying the issues facing Europe. It is the reports on the deliberations of these leaders, the proposed plans, and the criticism and praise following each release that caused, in large part, the surges and declines in global markets during the quarter. Each pronouncement of a deal was met with a strong rally, and each note of pessimism about a given plan was met with a severe decline. This is the market that we have come to live with the last few months.

The Federal Reserve embarked on its newest plan to jump start the ailing economy. The plan has been dubbed “Operation Twist” after its goal of twisting the yield curve by rejiggering the Fed’s balance sheet to bring down long-term Treasury yields. In other words, the Fed plans to sell some of the short-term bonds it currently holds and use the proceeds to buy long-term bonds, thus pushing the price up and the interest rate down. Whether a direct result of the Fed plan or investors simply anticipating the Fed’s action, the effect has been the 10-year Treasury yield below 2% and 30 year mortgage rates under 4%.

The U.S. lost its coveted AAA credit rating during the quarter as Standard and Poor’s lowered its rating to AA+. The move was more symbolic than meaningful in any economic sense. In fact, the yield on U.S. Treasuries plummeted in the months following the announcement, rather than rise as would be expected following a downgrade. Nonetheless, the message should be clear; the fiscal path the country is currently on is not sustainable. The U.S. is not in any imminent danger of being unable to pay its bills, despite the scare from politicians taking the country to the brink of default early in the quarter. However, fiscal sanity must return to the nation’s capital. A congressional super committee has been tasked with finding over \$1 trillion dollars in savings over the next decade. Should they fail to reach a consensus, automatic cuts are set to take place.

Additional volatility in global markets would not be surprising as Europe continues to debate the best course of action to contain its debt problems. Furthermore, investors here in the U.S. are reassessing their views of domestic economic growth over the near-term. However, the stock market appears to have priced in a great deal of the current stresses making headlines. Quality, blue chip stocks are trading at single-digit PE multiples, while the broader market trades at a low double-digit PE multiple. Tack on a 2% - 3% dividend yield and the market looks reasonably attractive for those with an appropriately long-term investment horizon. It is reassuring to remember that regardless of near-term volatility, a company’s stock ultimately provides a return to investors commensurate with the earnings growth of the company. We favor companies with handsome rates of earnings growth with the knowledge that similar rates of return will follow.