



# Special Market Update

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## Debts, Downgrades and Double Dips

On Thursday, August 4, the S&P 500 Index fell 4.8%, and was followed by another highly volatile trading day on August 5.<sup>1</sup> Then late on Friday, August 5, Standard & Poor's (S&P) announced its decision to downgrade the U.S.'s long-term credit rating from AAA to AA+, with a warning that it could be downgraded again in the future, sending the stock market tumbling again on Monday, August 8. This special update aims to address the factors that caused this volatility and provide some perspective for concerned investors.

### What Events Led to the Equity Market Correction?

We believe the market's tipping point was the delayed vote on the debt ceiling increase in Washington. Politics added an element of uncertainty that was previously not a major concern for investors, and this became a catalyst for investors to reconsider their investments.

Amplifying this loss of confidence was a backdrop of a deteriorating domestic economy, the intensifying sovereign debt crisis in Europe and the threat of the U.S. being downgraded by S&P, one of the top three ratings agencies (which it later was, as announced by S&P after market close on Friday, Aug. 5. The other two key ratings agencies, Moody's Investors Service and Fitch ratings, had kept long-term U.S. debt at the highest rating).

In the U.S., particularly noteworthy was the July reading of the Institute of Supply Management (ISM) manufacturing index, which has registered a nine and a half point drop in the past 90 days. Only once in the past 50 years did the economy not fall into recession with such a decline.<sup>2</sup> Furthermore, recent reports showed the U.S. manufacturing sector growing at the weakest pace in two years and the service sector growing at the slowest pace since February 2010.<sup>3</sup> The Organization for Economic Cooperation and Development (OECD) composite leading indicator also turned negative (-0.2%), which threatens U.S. export growth, one of the few bright spots in the economy.<sup>4</sup> Meanwhile, the downgrade of U.S. debt seemed inevitable as the agreement to raise the debt ceiling lacked a solution to reduce the federal balance sheet at a level S&P found acceptable.

In Europe, during the second quarter, interest rates and credit default swaps began to spike higher in the European peripheral countries as investors began to doubt Greece's ability to meet their upcoming funding needs.<sup>5</sup> S&P lowered the sovereign debt ratings in Portugal and Ireland, effectively shutting them out of the capital markets.<sup>6</sup> In July, the European Central Bank announced a second bailout package through the European Financial Stability Facility (EFSF), which was more satisfactory than previous policy

solutions but still fell short in three key areas, in my opinion. First, the size of the fund was not big enough to prevent a crisis in Italy and/or Spain if one were to occur there. Italy has €500 billion of government debt rolling over in the next three years.<sup>7</sup> Secondly, the guarantees need to be pooled rather than individually allotted. Lastly, its new powers still needed to be ratified.

As a result of these events, in the week of Aug. 1, the S&P 500 Index and the Stoxx 600 Europe Index had their worst weekly declines since November 2008, declining 7.2% and 9.9%, respectively.<sup>8</sup>

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### **What can investors do?**

Before you do anything, I hope you will take a deep breath, don't panic and stay the course.

We've had corrections before. Since the market recovery began in March 2009, there have been eight days the S&P 500 Index declined at least 3% or more. Although past performance is no guarantee of future results, the index on average was higher two months later, up 8.8%, according to Ned Davis Research.<sup>9</sup>

In fact, the current climate looks a lot like that of a year ago. Last year at this time, the economy was slowing, the risk of a double-dip recession was rising and the S&P 500 Index broke below important technical levels, only to go on to rally the rest of the year.<sup>10</sup> That said, the S&P 500 Index is still searching for a bottom, in my opinion. During such times the market tends to trade on emotion instead of fundamentals. Volatility is likely to remain elevated until we get a policy response or economic data that investors believe reduces the risk of a recession.

There have also been sovereign debt ratings downgrades before, although investors are justifiably concerned because it hasn't happened to the world's main reserve currency. Since 1986, there have been nine instances of a developed nation losing the highest rating.<sup>11</sup>

As for the double-dip recession fears, I believe the equity market may have overreacted to current conditions. Much of the disappointing economic data can be attributable to the increase in commodity prices, especially oil. Since 2002, real retail sales growth in the developed markets has tended to move with the price of oil with about a one- to three-month lag.<sup>12</sup> As such, the stabilization in commodity prices alone could translate to an increase in spending growth to over 3% (annualized).<sup>13</sup> Since April, oil prices have declined almost \$50 a barrel, with most of the decline occurring in July.<sup>14</sup> Lower energy prices act as a global consumer tax cut, which tends to drive spending higher. With inventories low, any increase in demand would likely drive manufacturing higher and have a positive effect on job growth, which recently surprised to the upside. The risk of Europe's sovereign debt crisis negatively impacting the U.S. equity market or banking system also appears overdone, in my opinion.

So, continue to monitor the situation but stay the course. I believe the U.S. equity market has more upside than downside at current levels. The S&P 500 index is as undervalued today as it was in March 2009 (at 13.15 times when measured by the price to earnings ratio).<sup>15</sup> The S&P 500 implied earnings growth rate for the next five years, at -9.5%, is as low as it was in August 2010 and March 2009.<sup>16</sup> Money supply is exploding to the upside, which is usually positive for equities.<sup>17</sup> Corporate earnings are likely to continue to surprise to the upside as a weak dollar provides pricing power and the ability to gain market share, in my opinion. Strong corporate balance sheets should enable them to weather the storm. In times of uncertainty, noncyclical companies have tended to outperform on a relative basis. I believe this may be the beginning of a secular shift in market leadership to mega-cap stock outperformance, where fundamental investing outperforms momentum investing.

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## **What Next?**

The signs of a double-dip recession are growing but it's too early to confirm. Falling oil prices will likely increase consumer spending. Inventories are low, so any pickup in demand should spur economic growth. Don't underestimate the possibility of a global, if not regional, policy response that reduces uncertainty. Corporate earnings and balance sheets are strong. Valuations suggest much of the bad news is already priced in.

Of course, emotion will trump fundamentals in the short run, so there is always the chance the equity markets will overshoot to the downside. Longer term, the rating downgrade on U.S. sovereign debt should serve as a wake-up call to fix the lingering fiscal imbalances. Any improvement in the fiscal balance sheet will take time and require sacrifice, but I believe ultimately can move the equity market higher over the long term.

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## **Important information**

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- 1 Source: Bloomberg News, "Most U.S. Stocks Fall as S&P 500 Completes Worst Week Since 2008," Aug. 5, 2011
  - 2 Source: Gluskin Sheff, Aug. 2, 2011
  - 3 Source: Bloomberg News, "Stocks Slide Most Since '09 as Two-Year Yield Reaches Record Low," Aug. 4, 2011
  - 4 Source: Credit Suisse, via Reuters Knowledge. Aug. 3, 2011
  - 5 Source: Bloomberg, L.P., July 31, 2011
  - 6 Source: Bloomberg, L.P., Aug. 8, 2011
  - 7 Source: Ned Davis Research, Inc., July 14, 2011
  - 8 Source: Bloomberg News, "Most U.S. Stocks Fall as S&P 500 Completes Worst Week Since 2008," August 5, 2011, and "Euro-Area Crisis Call Looms as Officials Race to Stem Tumult," Aug. 7, 2011
  - 9 Source: Ned Davis Research, Inc., Aug. 5, 2011
  - 10 Source: Ned Davis Research, Inc., Aug. 5, 2011
  - 11 Source; Gluskin Sheff, July 28, 2011
  - 12 Source; JP Morgan, via Reuters Knowledge. July 29, 2011
  - 13 Source: JP Morgan, via Reuters Knowledge. July 29, 2011
  - 14 Source: Bloomberg, L.P., Aug. 8, 2011
  - 15 Source: Bloomberg, L.P., Aug. 5, 2011
  - 16 Source: Goldman Sachs, Aug. 2, 2011, data as of July 29, 2011
  - 17 Source: Bloomberg, L.P., July 25, 2011

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The S&P 500® Index is an unmanaged index considered representative of the U.S. stock market. An investment cannot be made in an index.

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