U.S. Market Report

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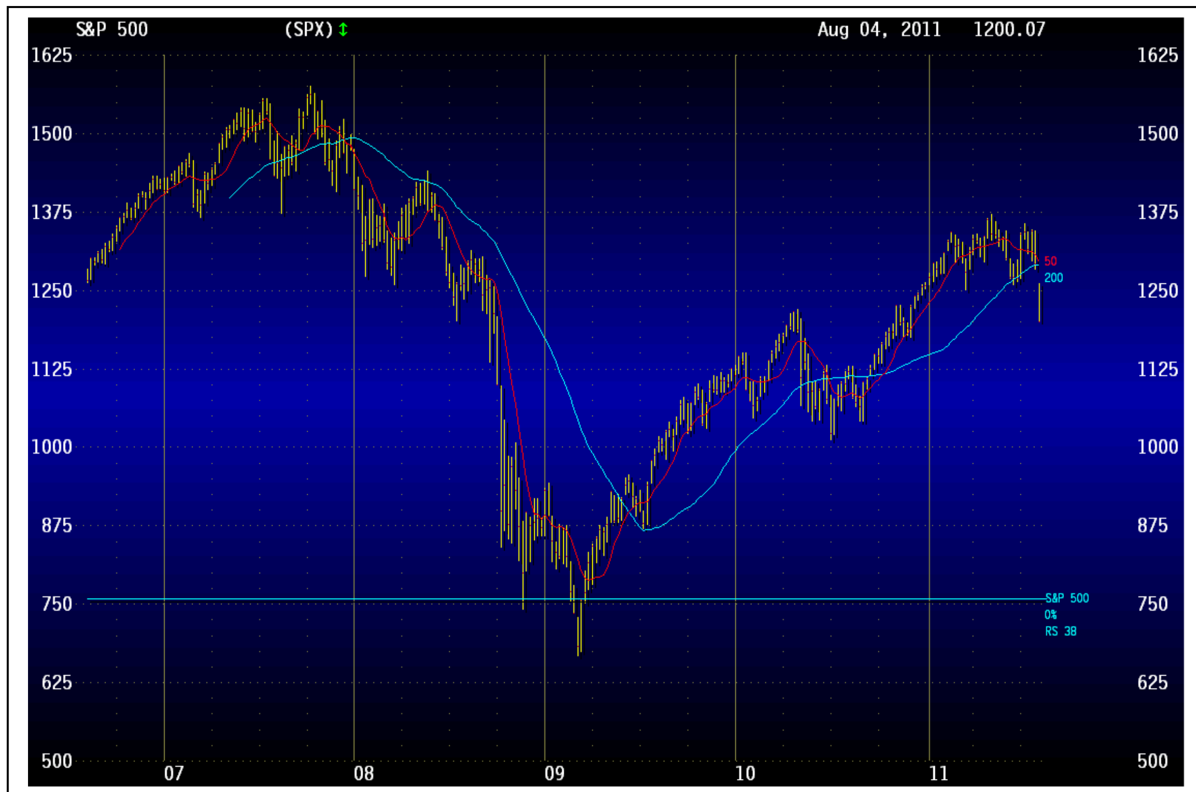

REVIEW & OUTLOOK

Stocks are heading lower again after Standard & Poor's downgraded U.S. sovereign debt to AA+ from AAA. The decline reflects a new level uncertainty. However, US borrowing costs are actually falling! The drop in stock prices comes on top of an 11% decline over the past 2 weeks. There has been a huge amount of speculation about the implications of the debt downgrade, but very little clarity. With Moody's and Fitch keeping the US rating at AAA, there may not be much immediate effect other than a further loss of confidence by investors, producers and consumers alike. Longer term, additional downgrades could cause rising stress in the banking and financial markets since US treasuries are used for collateral and financial participants may effectively be required to increase collateral balances. It also has implications for organizations ranging from Fannie Mae to the IMF and the World Bank who derive significant financial backing and support from the US. But keep in mind that this is all rather theoretical. As of this writing, 10 year US treasury bonds were yielding only 2.38%, down from 2.57% last Friday

before the downgrade and 3.12% a month earlier. Also, interestingly, the dollar strengthened against the Euro after the announcement, although may more reflect the decision by the ECB to purchase substantial amounts of Spanish and Italian debt.

The Standard & Poor's decision was based upon their perception that the political climate in Washington would preclude the passage of an agreement that will substantially cut the budget. Ironically, S&P's move actually increases the likelihood of an agreement. After the recent debt ceiling battle, we had little confidence that a grand agreement could be reached that would reform and lower entitlements like Social Security (government benefits for retirement and disability), Medicare (government healthcare for the elderly) and Medicaid (government healthcare for the poor). However, we now think the chances are at least even that before the end of this year there could be an agreement that does just that as well as a "reform" of the overly complex U.S. tax code that will raise revenues for the government. Call us hopeless optimists: The political heat is rising sharply and Obama and the politicians in Congress are facing increasing pressure to act. Recent polls shows rising unpopularity of all concerned.

It is said that Markets oscillate between fear and greed. Equity securities still offer the best opportunities for investors who can tolerate volatility, but the markets are now soaked in fear and we may see some further weakness in the weeks ahead. With the silly drama of the entirely political "debt ceiling crisis" over, markets have moved the focus toward the possibility of a double dip recession, as well as the ongoing sovereign debt problem and bank risk in Europe. These risks are real but maybe also setting up the foundations for next big upward move in equity prices.

The S&P 500 is down 12% since the recent high of 1363.61 on April 29th, and the worst performance has been in some of our favorite areas: Industrials (-18%), Materials (-15%) and Energy (-15%). The weakness in these sectors reflects their dependence on global growth and the economic data has recently been surprisingly weak. First quarter real GDP was revised down to a 0.4% annualized rate, and the initial reading for the second quarter was a lame 1.3%. Other data, including the ISM manufacturing index and employment growth, have also been weaker than anticipated and these factors have taken a toll on cyclically sensitive stocks.

While the recent weakness is painful, there are many good opportunities ahead for those cyclical sectors. In the case of energy and materials, long term global growth, particularly in places like China and India, are driving demand for resources upward faster than supply growth. Consequently, unit volumes, prices and profitability are likely to grow at above average rates over time. And the outlook for U.S. industrials remains bright too. While both the government and household sectors struggle to reduce debt, the U.S. corporate sector, notably industrials, are awash in cash and have very strong balance sheets and ongoing cash flows. High unemployment depresses wages. The cash returns from these businesses are accruing to shareholders in the form of higher profit margins rather than in the form of wages in the pockets of workers. Furthermore, exports and earnings from foreign operations are being boosted by the weak dollar. In the last decade the U.S. household sector increased its leverage and trade deficits ballooned. Now the trend has reversed. Households are deleveraging and the trade deficit is narrowing and is now a contributor to growth. Many U.S. industrials are benefitting greatly through increased sales to Asia and Latin America. This is a trend that is likely to last for many years to come and we think it is prudent to tolerate these largely unpredictable swings in market sentiment and stay with the most attractive fundamentals even when painful volatility strikes.

The proximate cause of the current correction in stock prices, as well as the slowdown in growth, is a spike in demand for liquidity and safety. This is about emotion. Swings in emotion are perhaps the greatest reason why predictions of stock price movements is so fraught with problems. It can be like trying to predict your teenage child's mood before they wake up. Two year U.S. treasury notes are yielding a paltry 0.29% and even yields on 10 year US treasury bonds have dropped sharply to only 2.4%

because of such strong demand for liquidity and safety. Banks have begun to charge large corporate depositors a fee—effectively a negative interest rate—on large cash deposits. And even though the M2 money supply is up a fairly sizable 6.0% year-over-year as of June 30th, *nominal* GDP (i.e., current dollar spending) was up only a weak 3.7% because people are still trying to hoard cash rather than spend it. It is this type of thinking, which derives from fear and panic, that leads to extreme volatility in stock prices. However, over time fundamentals will dominate.

A change in market psychology can be sudden and stock prices can spike higher. This is why we still hold large equity positions even though we have taken profits in some stocks and raised some cash. What can cause a shift in psychology? It was last August during a speech to central bankers in Jackson Hole Wyoming that Fed Chairman Bernanke signaled his willingness to provide more liquidity in order to avoid a double dip recession. His willingness to implement QE2 sparked a 28% rally in stock prices over the following eight month period. Right now, Bernanke is under some pressure not to do a QE3 because the headline inflation figures have been relatively high because of energy prices and there are political opponents of the Fed on the right side of the political spectrum that blame QE1 and QE2. However, like the stock market, crude oil peaked at the end of April and has now fallen to $86 per barrel from the high of $114. We expect to see the inflation number soon turn much lower and there will be new talk about the return of deflation. What is tying all this together? The demand for safety and liquidity! Already there have been news reports of former Fed officials calling for the Fed to provide liquidity by resuming the purchase of fixed income securities. As the inflation figures improve, and especially if equity prices move lower, these calls for QE3 will grow louder. People are demanding liquidity and it is the responsibility of the central bank to provide it. In fact, we would speculate that the next move could be a coordinated response by the Fed, the ECB and the Bank of Japan. Call it EQ^3 (QE-cubed). The rise in demand for liquidity is global. And if central banks respond appropriately, expect economic growth to accelerate and stock prices to jump sharply higher.

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