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A Crisis of Confidence

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Equity markets around the world fell in dramatic fashion yesterday. The S&P 500 Index fell by 4.78 per cent on Thursday, which was, according to data going back to 1928 the 84th worst trading day in the history of the index's 20,990 trading days. The index has fallen 10.8 per cent in the past nine trading days. The S&P/TSX Composite Index fared slightly better with a loss of 3.40 per cent on the day and a drop of 8.3 per cent since July 22.

Last week markets seemed ready to come unhinged at the prospect of the U.S. Senate and Congress not coming to a deal to raise the debt ceiling before the August 2nd deadline. However, following the President's signing on Tuesday of legislation that raises the U.S. debt ceiling, which also included measures that are intended to reduce current and future budget deficits, the markets continued their decline that at that point had lasted eight days. As such, reaction indicate that the conclusion to the political drama of the past couple of weeks was, when coupled with weaker economic data, a lose-lose situation. On the one hand, failing to raise the debt ceiling could have potentially resulted in a situation whereby the U.S. "would otherwise default on its obligations" according to the U.S. Treasury. On the other hand, passing legislation to raise the debt ceiling also includes provisions that would reduce the deficit by US$2.1 trillion over the next decade. It is an austerity plan that while necessary, comes at a time of weaker economic growth. Calling into question the sustainability of the recovery.

Recent economic data out of the United States would indicate that the soft patch in the economy was deeper than initially thought. The ISM Index for July came in at 50.9, a fall from 55.3 over the prior month (a reading over 50 indicates expansion) and a fall by almost 10 points since April. Additionally, the U.S. economy grew at a much weaker than expected pace in the first half of the year with second quarter GDP results of 1.3 per cent annualized and a significant downward revision to the first quarter estimate from 1.9 per cent to 0.4 per cent, also on an annualized basis. These data led investors to seemingly price in a double-dip recession. Equities were abandoned, commodity prices fell sharply and U.S. Treasuries were, once again, the safe-haven trade. Yields on the U.S. 10-Year Treasury fell to 2.41 per cent yesterday.

Jonathan Popper, Managing Director and Portfolio Manager for the Manulife Monthly High Income Fund comments, "The concern have moved from the U.S. debt ceiling and the budget to general economic conditions of which some, but not all, economic indicators indict have shown signs of slowing. We're bottom up investors that focus on company fundamentals - which remain favourable. Today represents an opportunity to buy good companies at a discounted price."

Dan Janis, Senior Vice President and Senior Portfolio Manager for the Manulife Strategic Income Fund comments, "This isn't an economic crisis, nor a debt crisis. This is a crisis of confidence. Investors are betting on a double dip recession, however we feel this is an unlikely scenario. More likely this is a period of summer weakness where markets are prone to irrational trading activity. We put the probability of a double-dip recession at less than 20 per cent. This is simply a soft-patch in the economy that comes at a time of weaker investor sentiment.

"Unfortunately, the actions of U.S. politicians over the past few weeks, coupled with the ongoing European debt issues have eroded investor confidence. Now is the time when we need clarity and direction from the ECB (European Central Bank) and the Federal Reserve. In the past couple of days we have seen the Swiss and Japanese central banks step in to weaken their respective currencies - it remains to be seen how successful they will be.

"What was interesting with the sell-off is that high yield bonds did not fall by as much as might otherwise be expected. Which benefited our portfolio. Our viewpoint and strategy has not changed. We continue to believe investors need to embrace credit and currency risk. That is, the health of corporations has rarely been better and the emerging market economies continue to perform well. Putting the 'noise' of the past few months aside, fundamentals remain intact."

In summary, unlike 2008 and 2009 where it was sub-prime related securities that brought the market down, this recent sell off appears to be more fear driven than fundamental driven. Actions of leadership has eroded investor confidence. Yet perhaps the only thing that is broken this time around is investor resolve. I am reminded of what Warren Buffet once said, "Be fearful when others are greedy and greedy when others are fearful."

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