

A bad two weeks – What does it mean?

It has been a truly horrible two weeks for global stock markets. The catalysts are clear: a bruising debate over the U.S. debt ceiling, an escalating crisis in European banking, evaporating confidence in the U.S. and global economic recovery, and more recently, a downgrade of the U.S. sovereign credit rating by Standard and Poor's.

Debt Ceiling Drama

Mercifully, the U.S. debt ceiling was raised last week, going some distance to resolving a long-boiling issue. Yet its legacy remains problematic in two ways. First, all of the political wrangling that led up to the deal (and similar dithering in Europe over a Greek bailout) has seriously compromised market and economic confidence. Second, the debt ceiling debate has highlighted a bigger issue: U.S. fiscal imbalances remain substantial, and political dysfunction renders a solution elusive.

While we acknowledge these two issues, we believe the U.S. fiscal position is fundamentally different from that of Europe. The U.S. has the capacity for dynamic economic growth and possesses plenty of fiscal spare capacity to right its imbalance. While political partisanship is on the rise, there seems also to be a basic acknowledgment of the tremendous threat presented by fiscal mismanagement – progress of a sort. Additionally, the U.S. dollar enjoys the privilege of being the world's reserve currency, giving the country extra time and space to find a solution.

Europe's Fiscal Plight

Europe's fiscal problems are rather more burdensome. We have long acknowledged that Greece is likely to default on its debt, and that Ireland and Portugal are at significant risk as well. Recent bailout plans have gone a considerable distance to accepting and addressing this reality, but are still shy of the full heft required (and still need to be passed into law). Still, we believe additional funds will eventually be applied and that the consequences of default among this trio should hopefully be manageable (though not likely without causing further market stress), as long as the European banking sector is protected from systemic collapse. A key part of the latest bailout plan envisions several mechanisms to do precisely this.

Complicating matters, the bond market has begun to sour on Italy and Spain, which threatens to increase borrowing costs for those nations. Despite the European Central Bank's decision to support prices for Italian and Spanish government bonds, the whole topic remains troubling. The economies of both countries are many times the size of Greece, and the cost of a bailout would be enormous, and quite likely unworkable. The good news is that Spanish and Italian fundamentals are not that bad. Italy has a big government debt, but a very small deficit, frugal households, healthy banks, and most of its debt doesn't mature for a long time, and is held domestically. Spain has a big deficit, but a smaller debt than the European average, and has enjoyed considerable success in its

austerity programs so far. Both of these nations should be able to avoid the worst of the market's ravages, especially if they manage to accelerate their fiscal austerity programs. Meanwhile, the European Central Bank has begun battling speculators by purchasing government bonds in the secondary market.

Ailing Economic Recovery

Many forecasters – ourselves included – had pencilled in an economic recovery for the second half of 2011. This simply hasn't happened yet. The recovery in the economy has been frustrating, even though the temporary factors that depressed growth in the first half have indeed unwound as we had projected. Japan's economy is now rebounding after its devastating tsunami, and oil prices are substantially lower than during the opening act of the "Arab Spring."

What has gone wrong? Simply put, the aforementioned loss of confidence due to political dithering in the U.S. and Europe has seriously damaged business, household and investor confidence. Businesses and consumers elected to defer spending and investment decisions until the uncertainty had passed, resulting in a lost quarter of growth. In turn, the vast majority of economic figures are worse than they were three to six months ago. We can expect that business and consumer confidence will be somewhat slower to return, given recent market turmoil.

But most indicators still do not signal a risk of recession. Most forward-looking indicators continue to signal diminished growth, not recession. Whereas simple models establish the risk of recession at anywhere between 0% and 90% – a range so wide as to be useless – we put it at around one-in-three. This is materially worse than a few months ago, when the odds were closer to one-in-ten. What's more, the latest U.S. employment figures, while admittedly backward-looking, also endorse a modest recovery. More generally, it is useful to remember that years of tepid economic growth are the norm after financial crises. For a while, it appeared that the global

economy might manage to defy that prophecy, but no longer. We have responded to recent adverse effects by moderately downgrading our economic forecast for the coming year. Broadly, the recovery is still on, but it is of a humbler variety.

Debt Downgrade

Last Friday evening, Standard and Poor's downgraded the sovereign credit rating of the United States by single notch. While this was a surprise to markets, it was not a total shock, as S&P had already put the U.S. on creditwatch. While we have only had one business day since the announcement, and we may yet be surprised, we do not expect the downgrade to affect the overall functioning of the financial system. Importantly, two other credit-rating agencies have left the U.S. at their top rating. Nevertheless, Standard and Poor's downgrade highlights the fiscal challenges and political issues that the U.S. does face, and could further damage confidence and harm the already modest economic recovery.

Déjà-Vu Debunked

As markets correct, it is tempting to draw a link to the events of the fall of 2008, when markets crashed after Lehman Brothers failed. There are, however, more differences than similarities. For instance, we have a reasonable grasp of the likely transmission mechanisms from Europe or a U.S. slowdown into markets. By contrast, as the U.S. banking sector crumbled in late 2008, it was anyone's guess where the next market fracture would appear, and this was a crucial element of the chaos. Currently, credit markets are functioning relatively normally. In late 2008, credit markets were essentially closed, threatening the existence of a broad swath of banks and businesses. In retrospect, the U.S. government made a mistake in allowing Lehman Brothers to fail, as it unleashed economic carnage through the serial correlation of risks in the credit system. Governments have learned their lesson and are unlikely to allow a repeat of something like this.

Bouncing Back

What will it take to get market confidence back? The first and most important ingredient is time. Sentiment rarely snaps back as quickly as it comes undone. Moreover, it will take a few months to properly establish whether the global economy continues to swoon, or if a rebound has begun. Similarly, even an intermediate solution to Europe's fiscal problems will take several months to achieve as seventeen national parliaments first need to pass the bailout plan. To be sure, sentiment could begin to improve in the near term if comments from Fed Chairman Bernanke hint at additional stimulus, or if ongoing meetings among European leaders yield a constructive outcome. But there is much to fret about in the world, and markets are arguably more attuned to the negative than the positive right now.

Capital Markets

Whatever chance existed for monetary tightening before next spring or summer has been dashed. The fragility of the current recovery and quick reflexes of capital markets have pretty much determined the bias of monetary and interest rate policy over the forecast horizon.

Longer-dated fixed income products are in a very different condition. If a recession were to occur, no doubt those seeking a safe haven and the threat of deflation will validate current prices, or even drive bonds higher. To us, the current attraction in bonds is limited to their status as a safe haven in crisis and as a hedge against recession. As the risks that burden markets ultimately diminish, today's premium valuations on government bonds can be expected to moderate, and yields will rise. Signals from corporate credit markets are especially valuable in a crisis. Over the past month, spreads have certainly widened, but the shift has been orderly, in sharp contrast to movements through the fall of 2008. The gap between yields on government and all grades of corporate bonds have opened up, with the biggest change in the lowest quality product. Across the spectrum, though, spreads

still lie below the levels of last quarter, last year, and far below those of late 2008/early 2009. Provided recession is avoided, spreads will narrow in the months ahead, providing some offset in bond portfolios as interest rates eventually return to levels seen a few weeks ago, and higher.

We acknowledge that it's a tough call to be buying stocks in this environment considering the massive technical damage to markets, the bust in confidence, and threats to margins and earnings in a weaker-than-expected economy. A little math is useful here. Trailing 12-month earnings for the U.S. market are just over \$90. At that level, the price/earnings ratio is 13.25 – exactly one standard deviation below the level common to periods with similar inflation and interest rates. Valuations could, of course, fall further. Two standard deviations below the norm rests at 9.3 times earnings, and the earnings base would surely fall in a recession. A two standard deviation move, though, is improbable. We saw that level at the most intense moments of the crisis in the spring of 2009 and, by definition, we will visit such discounts less than 5% of the time.

In Canada, valuations are solid, but somewhat less compelling than elsewhere. The boom in commodities and mid/smaller capitalization companies has provided much stronger gains since the last cycle low, so prospective returns are perhaps not quite as attractive as those in the U.S. and other global markets.

We would only be guessing at what the next few days or even weeks will bring. It isn't reasonable for us to predict when the market will bottom. But we expect that recession will ultimately be avoided, and we are taking steps to capitalize on the opportunity evident in our base case economic scenario. We believe that, barring recession, current valuations will ultimately be judged as very attractive – attractive enough to provide better-than-average returns from equities for those who take positions at today's levels.

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