

## ***A Short-term Panic or Something Worse?***

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The stock market has dropped about 13% in the last 11 trading days—by any historical measure an extremely sharp and swift correction in prices. Is this a transitory panic or the beginning of a new bear market in stocks which could drive prices lower by 20% or more in the months ahead? What are the implications for interest rates due to the recent Standard & Poors rating downgrade of US debt?

To be sure, the economic conditions that sparked the recent stock market decline are very serious. Most important is the European sovereign debt crisis which has spread from the relatively small economy of Greece to the larger economies of Italy and Spain. The fear is that Europe's sovereign debt crisis in 2011 will be analogous to the US subprime debt crisis in 2007, i.e., the beginning of a debt fueled economic contagion that leads to another global recession and financial panic.

Conditions here in the US have also caused investor concern. Last Friday night after the markets closed, S&P downgraded US Treasury debt to AA+ from AAA for the first time in history. In doing so, the S&P removed the US from "CreditWatch", but maintained a negative outlook, meaning that S&P could issue another downgrade within the next two years. S&P believes the deficit reduction deal reached by lawmakers in connection with debt ceiling negotiations didn't go far enough in reducing the nation's federal budget deficits. During the week preceding the S&P action, both Moody's and Fitch reconfirmed their AAA rating on Treasuries. Now US debt is "split" rated: AA+/AAA.

What's more, our anemic economic recovery from the Great Recession appears to be stalling and the political theatrics surrounding the debt ceiling negotiations further eroded confidence in our political leadership regardless of one's party affiliation.

The following, in question and answer format, are our views on the debt downgrade and other recent economic trends affecting the capital markets.

### **Is the debt downgrade a big surprise for the capital markets?**

It shouldn't be. The deteriorating balance sheet of our federal government (too much debt relative to the size of our economy, i.e., a rising ratio of debt to GDP) has been a source of investor concern for over a decade. This concern has intensified in the last year. In April, S&P changed the rating outlook for the US from positive to negative. In mid-July, both Moody's and S&P put the US on CreditWatch. Indeed, in addition to the weaker than expected economic growth, we believe part of the reason for the recent stock market sell-off was due to investor disappointment with the debt ceiling negotiations and the growing possibility of a debt downgrade by S&P.

### **What is the likely impact on interest rates?**

In the near-term, we expect the typical flight to quality that accompanies nervousness in the markets. AA+ is still considered "high grade" credit where the likelihood of getting paid back is "very strong." With global economic growth slowing, increased concerns about a sovereign debt crisis in the euro zone, and high unemployment, US Treasuries still have strong appeal as a "safe haven." What's more, US Treasuries occupy a special place in the global financial system: the US is the world's largest economy, Treasuries are the world's largest and most liquid fixed income market, and the US dollar is the world's reserve currency which foreign central banks must hold for purposes of transacting international trade. In the past, Japan, Canada and Australia have lost their AAA rating without a noticeable increase in their borrowing cost. Japan, for example, has a AA rating and their interest rates are lower than the US.

Over the intermediate term, the path of rates will be dependent on the trajectory of US and global growth. A rebound in the US economy in the second half of 2011 to modest growth will relieve pressure on the risk assets and will likely push interest rates higher, particularly for intermediate term maturities. In bond portfolios, we believe a "barbell approach" (a combination of short and longer-maturities) will outperform intermediate maturities.

Over the long term the interest rates on US treasury debt may be moderately higher as a result of the downgrade. If we enter a period of sustained economic growth with no progress in reducing our fiscal deficit, then an AA rated US could be expected to pay slightly higher borrowing costs than an AAA rated US.

### **What is the likely impact on the US economy?**

In our view the debt downgrade is likely to have a modest negative impact on US economic growth. By itself, it's unlikely to push the economy into recession, but it is just one more reason for US consumers to lack confidence to spend on big ticket items like housing.

On the positive side, the debt downgrade highlights the fragility of the economic recovery and will keep short term rates lower for a longer period of time. In addition, the debt downgrade should put increased downward pressure on energy and industrial commodity prices. This would take some of the edge off inflation which has been rising in recent months. The downgrade should reinforce downward pressures on the US dollar. A lower dollar tends to raise inflation pressures because imports cost more, but a weak dollar also makes US based manufacturing more competitive on world markets and bolsters the earnings of US multinational companies.

### **What is the likely impact on the stock market?**

Over the next few weeks, stock prices could continue to drift lower as many retail investors view the downgrade as one more reason to avoid equities. Institutional investors like pension funds may take a "wait and see" attitude before doing any more buying, but we don't expect them to panic out of the market because there are few attractive alternatives to equities in our opinion. With interest rates this low, both the dividend yield and the earnings yield on stocks looks attractive versus most fixed income instruments. Plus, equities are generally a more liquid market than commodities, private equity, hedge funds, venture capital and real estate. And in an uncertain future, investors tend to value liquidity when making choices among risky assets.

In the intermediate term, say the next few months, we view any further stock market decline as temporary and a buying opportunity for investors. We think that much of the risk of a rating downgrade by S&P has been discounted by lower stock prices over the past two weeks. In short, we don't believe that the debt downgrade puts a nail in the coffin of the economic recovery or the bull market in stocks. Rather we see it as a short-term correction, much like the 15% correction which took place between May and June of 2010.

Our constructive outlook for stocks is based on five key observations and opinions.

- 1) Recessions and severe bear markets usually begin after a period of sustained economic growth and monetary tightening by the Federal Reserve. These conditions don't exist today.** Think about the market tops that preceded the recessions of 1980-1981, 1990, 2001 and 2008-2009. Each market top was preceded by a lengthy economic expansion which produced relatively low unemployment rates and relatively high rates of factory capacity utilization. What's more, in each case Fed tightening was severe enough to invert the yield curve, i.e., push short-term interest rates above long term rates. Today, the yield curve is very steep and there's lots of slack in the labor markets and product markets. These are not conditions that generally signal the end of a bull market or economic expansion.
- 2) While the economies of the US and Europe (about 45% of global GDP) are sluggish, the emerging market economies of Asia, Latin America and the Mideast are sufficiently strong to keep the world out of recession.** About 40% of S&P 500 earnings are derived from revenues outside the US. The 35% decline in the value of the US dollar over the past decade has made US-based manufacturing much more competitive on world markets. Together these factors have underpinned record earnings growth by corporate America over the past two years. We expect these forces to continue to bolster earnings in the year ahead, particularly for US multinational companies. Despite sluggish growth in the first half of 2011, we expect S&P 500 earnings per share to hit \$100 over the next four quarters. This exceeds the peak-of-cycle earnings of \$86 recorded in 2007 when the S&P 500 index traded at record levels of 1560, or about 30% above current levels.
- 3) Stock prices are attractive relative to bonds and money market instruments.** The current price/earnings multiple on stocks (estimated to be about 12 times 2012 earnings for the S&P 500) is historically low versus competing yields on fixed income instruments. In addition, the current average dividend yield on stocks at about 2% is relatively high versus money market and treasury yields (generally in the range of near zero to 3%). One of the reasons that bull markets end is that rising interest rates reduce the attractiveness of stocks versus bonds. Moreover, rising rates eventually reduce the growth prospects for the general economy. While we expect rates to eventually rise, they are unlikely to rise enough in the next 12 months to erase the advantage that equities have over bonds.

- 4) We believe that US economic growth will gain momentum in the second half of 2011.** Part of the reason for the recent slowdown is due to transitory factors: the economic disruption caused by the tsunami/earthquake in Japan, floods and tornadoes in the US and the bite on consumer disposable incomes caused by the spike in energy prices. As the negative effects of these early 2011 events dissipate, the economy should pick-up later in the year.
- 5) The US corporate economy is much stronger than the consumer economy and the government economy.** Equity investors need to think about the US economy in three parts—corporate, consumer and government. The corporate economy which drives the stock market is much stronger than the other two. It has benefited from the growth of emerging markets and an economic recovery led by industrial production, capital spending and export growth. (Unlike prior recoveries which are usually consumer led.) Corporate earnings are at record highs. Corporate balance sheets are generally strong with debt levels modest and cash levels high. Many corporations have used the prevailing low interest rate environment to refinance their debt at attractive rates or borrow in order to repurchase stock. The bad economic news of late has most relevance for the government sector of our economy which accounts for about 20% of GDP.

***So you think that interest rates will stay relatively low in the near-term, the economy won't fall into recession and the stock market will recover. That sounds pretty optimistic. What if you are wrong?***

The key risk to our forecast is that the US and Europe fall into another recession brought on by too much debt and a further deflation in asset prices (houses, stocks, commodities, etc.) Policy makers are in a pickle. Much of southern Europe can't spend to stimulate their economy because the markets won't allow them to borrow the money at attractive rates. Here and in Europe policy makers can't cut taxes too much because they need the money to pay their debts. And they can't increase tax rates too much because their economies are too weak to bear the burden.

In an economy burdened by heavy government debt, policy makers must find a near perfect balance between taxes and spending. Too much fiscal austerity (spending cuts and tax increases) could cause already weak economies to stall, taking away the much needed growth in revenues that these governments need to repay their debts. Too little progress in reducing the massive fiscal deficits, the higher the likelihood of debt

downgrades, higher interest rates, and even greater economic and fiscal headwinds down the road.

During the Great Depression of the 1930s, policy makers in 1937 raised taxes and cut spending to balance the federal budget. This tipped the budding economic recovery of 1934-1936 back into recession/depression. We believe that there's about a 25% chance that the US economy falls back into recession later this year. The chance of Europe doing so is about 40%. The probability of recession could go up as fiscal austerity measures take hold in 2012 and beyond. These are not insignificant risks for the world economy or global stock markets. ♣♣♣

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