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Post U.S. Credit Downgrade - The State of the Markets and Economy

What's Happening with the Global Equity Markets?

U.S. and international stocks took a severe beating last week and continued to sell off sharply on Monday, as investors around the world shunned risky assets in favor of traditional safe havens. From July 31st to August 8th, the broad based S&P 500 index lost -13.3%, the Dow Jones Industrial Average fell -10.9% and the MSCI EAFE index measuring developed international stock markets declined -12.9% in U.S. dollar terms. To put this market correction in perspective, recall that stocks have experienced volatility in the past; for example, over a four-week period in June of 2010, the S&P 500 dropped -15%.

What Is Causing this Market Downturn?

We believe a number of factors are contributing to the market correction. Some, like the European debt crisis, are not new. Others, like the downgrade in the credit rating of the U.S. government, were caused by more recent events.

The European sovereign debt crisis has been a cause of ongoing concern since the second quarter of 2010. The European Central Bank and central governments around Europe have repeatedly "kicked the can" down the road. The stock market's vote of no confidence might indicate that investors don't see a clear way out of this problem or are questioning how much firepower is left to help steer us out of this crisis.

Continued disarray in Europe over the Greek bailout plan added to the selling pressure in August as risk has spread from the periphery of Europe into its core. The European Financial Stabilization Fund (EFSF), whose funding was just increased to €440 billion, does not have the more than €2 trillion that some analysts say would be needed to bail out either Spain or Italy. Reaching €2 trillion in funding is unlikely, particularly since some of the most financially troubled countries are among the sixteen nations expected to contribute to the EFSF. As a result, the additional burden of funding will probably ultimately fall on Germany, which has already indicated its reluctance to be Europe's savior.

In our opinion, the European debt issue is not going away any time soon. Until the debt is written down or inflated away, the problem will likely continue to fester. Policymakers are concerned that write-downs would erode bank capital and threaten the stability of the financial system. One solution to avoid plunging European banks into bankruptcy is to allow the write-downs to be spread out over time. Losses could then be used to reduce future tax burdens. It is possible that Europe will more swiftly come to a viable solution but, as we have seen in the U.S., it is difficult for politicians to make tough decisions in a democracy.

Given the backdrop of existing European debt problems, investors were shaken by the political fight over raising the deficit ceiling and the recent downgrade of U.S. sovereign debt by Standard & Poors. Both Moody's and Fitch have affirmed their existing ratings. As a result, we don't believe that the credit downgrade will have a significant impact on bond yields.

Renewed concerns over the growing possibility of a double-dip recession have also contributed to the market correction. Although much rests on consumer confidence (which remains negative), we believe the economic data reported last week is more consistent with a slow growth environment than an outright recession. Last week we saw soft new factory orders and continued weakness in consumer income and consumption. However, motor vehicle sales were better than expected, suggesting that the supply chain disruption due to the Japanese earthquake is fading.

Unemployment claims were stable at 400,000, with no spike which would indicate recession. The Institute for Supply Management (ISM) Surveys, which measure economic activity, while soft are still above 50, again more consistent with slow growth than recession. Export orders were the strongest part of the most recent ISM report. Corporate profits continue to surprise to the upside, which should help boost business capital expenditure. Mortgage applications were also up strongly last week in response to much lower mortgage rates. Finally, oil and gasoline prices are falling, which should help consumer purchasing power. So, not everything is doom and gloom for the U.S.; there are glimmers of hope.

A U.S. economy with an accommodative Fed, strong profit growth, falling inflation and interest rates, and a positively sloped yield curve is typically not prone to recession. Still, the best leading indicator of the economy is the stock market, and it is clearly giving a loud warning signal. Although we believe that the U.S. economy can muddle along on the slow growth path, the risk of recession is rising.

What Are the Investment Implications?

Our portfolios remain diversified. In general, our moderate risk guidelines recommend a 50% allocation to global equities and a 50% allocation to non-equity investments such as cash, fixed income, real estate, gold, commodities and lower volatility, long/short market-neutral strategies, where appropriate. Following the lead of our tactical asset allocation models, we reduced our equity exposure in most accounts by approximately 8% last week. We continue to be flexible in our posture. While risks to the downside have increased significantly, we have to remember that market sell-offs such as this one can create great (often longer-term) buying opportunities. As investors, a risk we face is becoming too cautious at a time when the markets are already discounting a gloomy scenario. If policymakers surprise to the upside (and expectations are not high), we could see a strong rally in the equity markets. Flexibility and diversification remain the cornerstones of our investment management, and we expect that our global asset mix will serve us well through these volatile times.

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