



PERSPECTIVES FROM THE CIO

Recent Market Volatility

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On Friday, August 5, Standard & Poor's downgraded the United States from AAA to AA+. On Monday, August 8, the agency followed up by downgrading a range of securities whose ratings are dependent upon the support of the US federal government. These actions were not a surprise to the markets, as these moves had been well telegraphed by S&P, which put the US on CreditWatch negative on July 14 and was vocal about the 50/50 chance of a downgrade. Despite this downgrade, we still view US Treasuries (UST) as one of the safest and most liquid assets in the world. As has been demonstrated by the dramatic decline in equity markets and concurrent rally in UST over the last few days, the markets clearly agree with us. However, although topical, we do not think the fiscal and political issues in the US are the primary drivers of recent market volatility. They are one element in a broader "wall of worry" that is plaguing markets and investors. We believe that the fragility in markets and investor sentiment stems more from pessimism about growth in the developed world and concerns with peripheral EU countries than from the downgrade of the US.

Global Growth

The recent spate of negative economic data has dampened the market's belief in the recovery. This change in sentiment has many pundits now calling for a double-dip recession. The most recent GDP data showed an annual growth rate of less than 1% for 1H11, and recent manufacturing and employment statistics have been disappointing.

It is our view (and seemingly the view of US Federal Reserve Chairman Ben Bernanke) that these events and other transient factors—such as the earthquake in Japan, elevated oil prices and Middle East turmoil—have brought us near the point of maximum pessimism. We have already seen signs of recovery in Japan, and oil prices have declined substantially. While we have no expectations of significant growth, we do believe that the second half of 2011 will bring a modest rebound. Others believe that these events will lead to a continued erosion of US growth. At a minimum, wider spread levels in certain sectors of the market, coupled with 10-year yields falling below 2.4%, suggest that there is an incentive to selectively add small amounts to risk.

While we do expect a rebound, we are fully aware that downside risks have increased. That said, corporate balance sheets are very strong, and corporations have accumulated significant cash. Second, we have seen improvement in "consumer balance sheets" as consumers have reduced the amount of personal debt over the last three years, and the personal savings rate has increased to about 6%. This strengthens our view that the retrenchment in consumer spending should be temporary.

Although fiscal imbalances across developed nations have depressed growth recently, growth in emerging markets remains strong. While these nations will see reduced growth due to the marked slowdown in the US, exports from the US have increased by over 15% year-over-year (YoY). That being said, there clearly are still some secular headwinds to growth, including fiscal consolidation (both in the US and in Europe) and global deleveraging, which continues. In sum, while growth has clearly slowed in the short term and confidence has been shaken, there haven't been any structural changes to the global economy. Banks remain well capitalized, corporations are well funded, oil prices have decreased, interest rates have declined and valuations look far more attractive. These factors suggest to us that we should return to a modest growth rate going forward.

Peripheral European Union Countries

The second-most important contributor to the "wall of worry" has been uncertainty over how policymakers would respond to the growing debt crisis in European peripheral countries—particularly, whether policy errors

would be committed and result in contagion to other countries and markets. These worries resulted in a flight-to-quality into UST, a consequent decline in US interest rates, and poor performance in risk assets.

In July, policymakers began recognizing how critical Spain and Italy are to the success of the EU and put together a package that exceeded market expectations in terms of its scope. The package gave cheaper and longer-dated money to Greece, Portugal and Italy. It provided for some private sector involvement and expanded the mandate of the European Financial Stability Facility (EFSF) to allow it to purchase debt of other countries and to recapitalize the banking system. This was a good first step, but still does not provide sufficient debt relief. In addition, the package still needs to be approved by the member countries.

This issue will require substantial time to resolve. From our perspective, real answers would require more debt relief and some sort of a fiscal union, and we're still an awfully long way from either of those occurring. Previously, the European Central Bank (ECB) was hesitant to use its Securities Market Program (SMP) to purchase the debt of peripheral countries, feeling constrained by the amount of credit risk. However, over the weekend, the ECB reversed course and started buying Italian and Spanish bonds. This program is expected to remain in place until the EFSF is operational. Once operational, the EFSF's purchasing capacity will only be about €300 billion. This would not be sufficient to deter another bout of speculative behavior. To dampen market volatility, the purchasing capacity of the EFSF would likely need to be in excess of €1 trillion. This would then be large enough to cover Spanish and Italian refinancing needs. Additionally, Spain and Italy (and the rest of the European periphery) must display a clear trend of debt reduction and fiscal restraint in which even negative surprises such as slower-than-expected GDP growth would not derail the deleveraging process.

It will take years for Spain and Italy to stabilize their debt levels. We do not expect the EFSF to be enlarged without a crisis. Therefore, we expect ongoing volatility and more systemic stress points. It is an open question whether European policymakers have the political will to continue toward the establishment of a fiscal union.

Portfolio Strategies

During 1Q11, given growing uncertainty, we reduced spread risk, taking advantage of high valuations. Today, our belief that the slowing of global growth is likely to be transitory—combined with the stronger corporate fundamentals—leads us to selectively add risk assets as we find attractive opportunities.

However, we recognize the downside risk in these volatile markets, and so we supplemented our spread risk with duration and yield curve strategies that have helped provide stability to our portfolios in this time of extraordinary volatility. We think that the sources of worry driving market volatility will persist for an extended period. While this market volatility is a source of worry in itself, we believe it provides us with opportunities to generate returns on our clients' behalf. We will continue to make prudent evaluations of the risk/return trade-offs presented by these markets, consistent with our clients' guidelines.

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