

Investment Commentary—October 2011

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Three months ago we sounded a note of caution, observing that “governments on both sides of the Atlantic are struggling awkwardly to control debt.” Not much more than a week later, market worries over the twin debt crises in Europe and the U.S. surged and have yet to fully subside. It may be some time before they do.

Attention focused initially on the debt ceiling debacle transpiring in Washington. As late as July 22nd there was hope of a “grand bargain” between President Obama and House Speaker Boehner comprised of discretionary spending cuts, entitlement reform and new revenues totaling \$4 trillion. When the grand bargain discussions collapsed later that day, the stock market, then only two percent shy of its post-financial crisis high, proceeded to tumble (with a major assist from events in Europe; more on that below)—seventeen percent over the next couple of weeks all told.

Notably, a small but significant part of the Republican caucus was content to leave the debt ceiling in place. This genuinely held but radical view—not raising the debt ceiling would have been disastrous—gave Boehner the leverage to force Obama into a distasteful deal consisting of \$900 billion in cuts in discretionary spending and an additional \$1.5 trillion of deficit reduction to be agreed upon by a congressional “supercommittee.” Investors were aghast on the grounds of both substance—the difficult but crucial topics of entitlement reform and new tax revenue were deferred—and process—Senate Minority Leader McConnell himself characterized GOP tactics as hostage-taking and suggested the party would welcome the chance to do it again. The debt ceiling spectacle reached its nadir on August 5th when Standard & Poor’s lowered its rating of long-term U.S. debt to AA+.

Subsequent to the precipitous market decline in late July and early August there have been a series of sharp swings, with the S&P 500 Index completing several round trips between 1,200 or so on the high side and around 1,120 on the low end. During this period of almost bizarre volatility, concern shifted from the U.S. to Europe.

The European debt crisis is now well into its second year. It has proved very difficult to resolve for a couple of reasons. First, since the euro is a common currency, policymakers in the affected countries can’t devalue. As it makes a country’s exports cheaper and thereby lifts GDP, currency devaluation is often the most critical step in combatting a sovereign debt crisis.

The other reason the crisis is so vexing is the bewildering array of decision makers. At this writing, for example, Slovakia's parliament (Slovakia!) is threatening to wring concessions before approving the bailout plan announced in July. This diffusion of authority means that action is taken only under great duress, with bold steps vetoed by the most reluctant participants. Decisive action (particularly in restructuring Greek debt) has also been stymied by the prospect of triggering a banking crisis, the great fear of governments and investors alike. Unfortunately this inability to move aggressively has led to a dangerous incrementalism.

Scouring the vast discourse on the subject, one can discern agreement on the outline of a solution. The effective capacity of the European Financial Stability Facility should be dramatically increased (various schemes have been floated for achieving this). With this increased capacity in place (potentially augmented by additional commitments from the International Monetary Fund), European authorities should in one fell swoop recapitalize banks across Europe, force a much more dramatic restructuring of Greek debt and put in place a restructuring of Irish and Portuguese debt as well. European authorities should also set aside very large sums for future borrowing at modest rates by Greece, Ireland, Portugal, Spain and Italy, making extremely clear that restructuring is reserved Greece, Ireland and Portugal and that all necessary steps will be taken to protect Spain and Italy from that fate. Beyond these immediate steps, Europe would need to take measures to boost growth and create structures to achieve greater fiscal integration.

If a bold plan along these lines were implemented swiftly, the cloud Europe casts over the world economy could be lifted. At this writing, Germany and France are working together on a new plan which will be discussed at a summit of European leaders on October 23rd (delayed from October 17th). The focus of the plan seems to be bank recapitalization, which is appropriate and encouraging. With Germany and France announcing early this month that they were discussing a comprehensive plan and that the two countries were in broad agreement, stock markets around the world applauded. The S&P 500 Index surged over eight percent in five trading days. Color us skeptical. We expect a plan that is too narrow in scope (it's hard to imagine, for example, that it will contemplate restructuring Irish and Portuguese debt) and too slow in implementation to offer anything like a resolution to the crisis.

As if the two debt crises in the developed world didn't give markets enough to worry about, China appears to be in the midst of a significant slowdown. Authorities have been clamping down on bank lending and those efforts are taking hold. Ominously, global copper prices, which is widely regarded as a leading indicator, have been plunging over the last several weeks. Our sense is that Chinese policymakers will be nimble enough to prevent a hard landing, but there is cause for some concern.

Ironically, the outlook in the U.S. is slightly better than it appeared in early August when the market shed seventeen percent over the course of two weeks. Investors feared that the debt

ceiling debacle would spook businesses and consumers to the point of sending the U.S. into a recession. In the event, economic activity held up better than expected and estimates of third quarter GDP are in the vicinity of 2.5%. Tepid to be sure but a fair bit better than the first two quarters of the year. And the all-important Institute for Supply Management surveys for September indicated no loss of momentum (to the extent 2.5% growth can be called momentum) heading into the fourth quarter. Jobs surveys too continue to suggest weak but steady growth. If the U.S. were insulated from events in Europe and China, the odds of another recession in the foreseeable future would be quite low. Of course, we're not insulated and it's more than conceivable that the European debt crisis, or (less likely) a hard landing in China, could have deleterious effects.

Absent a major banking crisis in Europe, a recession in the U.S. would likely be mild, due simply to the fact that deep recessions usually involve precipitous falls in cyclical areas of the economy. Those sectors—homebuilding, durable goods consumption and business inventories for example—are more or less still bumping along the bottom and therefore unlikely to take a big tumble.

The impact on the stock market of a mild recession would probably be muted for two reasons. The first is that the miserable decline in the third quarter has rendered stocks quite cheap. We took a look recently at the thirty stocks in the Dow Jones Industrial Average and estimated the average reported earnings over the five years ending December 31, 2011. This is a period that included all of the Great Recession as well as the not so great recovery, so as a measure of earnings power, it's pretty conservative. In fact, it's reasonable to think companies could do better than that over the next couple of years even in the event of a mild recession. Using this conservative measure of earnings, the Dow¹ ended the quarter at a P/E of 13.7, with an earnings yield of 7.3%. That number looks very enticing when compared to less than five percent on investment grade bonds and less than two percent on Treasuries.

Of course the problem with attractive valuations is that they can always get more attractive. Still the well documented hordes of cash sitting on corporate balance sheets could serve as something of a firewall. Corporate CFOs are highly attuned to numbers like the 7.3% earnings yield cited above. Economic uncertainty provides some incentive to continue to stockpile cash. But at a certain point the returns available from repurchasing shares become too appealing to pass up. It's hard to know at what point market valuations are so low that repurchase activity surges and becomes a buffer against further declines. But if we weren't there at the end of last quarter, we may have been pretty close.

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¹ We focus on the Dow Jones Industrials rather than, let's say, the S&P 500 Index simply because the Dow's 30 stocks are much more manageable than the S&P's 500.