

August 18, 2011

Dear Client,

The storm of market volatility over the past two weeks has brought back still raw memories of the 2008 financial crisis and all its attendant fears. As is our practice under these circumstances, we pause for some reflection.

These sudden bursts of extreme market behavior only underscore that ours is an extraordinarily complex business – one that encompasses economics, psychology, politics, history, and even plate tectonics. It is beyond the capacity of either man or machine to accurately predict what will arise from the interplay of these forces. Perhaps that explains why the character trait I admire most in our business is humility, while the one that makes me most apprehensive is overconfidence.

Maritime metaphors are overused in our field, but I'll use one anyway. As manager of our clients' financial assets, we are both shipbuilders and captains. We build and, with a watchful eye, pilot a ship (client portfolios) through uncharted seas (the future), using rough maps of earlier voyages (history) and our own accumulated experience to make informed decisions as the sea unfolds before us.

The wise captain, though, understands the limitations of the process. The maps are informative, but not predictive. No two storms are identical. And the ship may even require modification while at sea in response to new experiences. The wise captain does not overestimate his control of outcomes. The wise captain is – well – humble.

With that prelude, let's take a look at the most recent market storm and see what sense we can make of it.

A Debt Ceiling and a Downgrade

The proximate causes of investor dismay last week were, first, the tortuous negotiations to raise the US debt ceiling, followed by S&P's near immediate downgrade of the US government's credit rating from AAA to AA+. We stated previously our confidence that the debt ceiling would be raised in time to avert disaster, and this proved correct. The negative political consequences of a default dwarfed any ideological priorities of the warring factions. The only question was what form the final compromise would take. In the end, the agreement called for cumulative deficit reduction of more than \$2 trillion over the next several years, mostly through spending cuts.

S&P's subsequent downgrade was curious. The firm cited America's large deficits, the consequent rapid growth of national debt, and a dysfunctional legislature. This is old news, some of it very old.

S&P might explain why it waited so long to act if these are indeed the real factors behind the downgrade. More likely, the downgrade reflected S&P's need to look tough after so thoroughly botching things in the subprime crisis and, more recently, in the European sovereign debt arena, in both cases maintaining its prized top rating long after the borrowers became severely impaired.

We would argue that, if anything, the debt ceiling accord was a positive development. Despite their huge differences, the House, Senate and President arrived at an agreement that both kept the lights on and made a small, but meaningful first step towards bringing the deficit under control. The next steps will be harder because they will involve the political poison of restructuring major entitlement programs, particularly Medicare and Medicaid. But at least we've seen that first step, and from it we gain cautious optimism that further steps can and will be taken.

A New Chapter in the Great Debt Unwinding

Chapter 1 of the great debt unwinding began four summers ago with the collapse of a pair of mortgage-based hedge funds, two small dominos at the start of a chain that ultimately toppled financial giants Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac and AIG.¹ The first chapter was about the deflating of the residential real estate bubble. By 2007, the American household could no longer borrow its way to further prosperity. A severe global recession ensued, followed by the weakest economic recovery in memory.

Chapter 2 is now officially under way, its arrival perhaps heralded (but not caused) by S&P's downgrade of US debt. In Chapter 2, it's the western sovereign governments (from the US to Greece and everywhere in between) that find themselves tapped out and no longer able to borrow their way to collective prosperity. Both monetary and fiscal policies have reached the point of diminishing returns, and it could fairly be said that Chapter 1 hastened the onset of Chapter 2. The Great Recession left us with slower growth, higher unemployment, and therefore less tax revenue. Combined with aggressive fiscal stimulus, this caused budget deficits to skyrocket, which in turn made the national debt take a sharp turn northward.

The Message in the Markets

Market movements both before and immediately after the S&P downgrade raise some very interesting questions. What's behind the stock market's recent correction? And why have Treasury yields plunged?

The debt ceiling package and the S&P downgrade together brought home for many the fact that austerity is moving from the household to the halls of government. In the short run, budget cutting usually dampens growth. Both the weakness in stocks and the strength in Treasuries are consistent with a slowing economy. Whether it's a temporary "soft patch" or another recession in the offing, a

¹ As well as Countrywide, Wachovia and Washington Mutual.

slowdown cuts the corporate earnings that underpin stock valuations, while also curtailing borrowing and therefore the price of money, i.e., interest rates.

In just 16 days, beginning July 27th, the yield on the benchmark 10-year Treasury fell from 3.01% to 2.24%, or 77 basis points. Over the same period, the yield on the 10-year TIPS (an inflation-indexed Treasury security) fell by 58 basis points.² From this, we deduce that the drop in interest rates was largely attributable to a worsening outlook for the economy, but also due in no small part to falling expectations for inflation. Since July 22nd, the S&P 500 US stock index has dropped about 12.5%, again consistent with a slowing economy.

Another unusual force may be at play. Bond yields usually rise after a downgrade, as bondholders demand more compensation for holding a riskier security. Yet in this case, Treasury yields dropped sharply after the downgrade, and by more than those of other government bonds around the world whose ratings were not changed. We might argue that US Treasuries were no better quality the day before the downgrade, and no worse the day after. But we cannot dispute the fact that market risk levels, across asset classes, spiked after the downgrade. If we think of investors as having a roughly fixed “budget” for taking on risk, then when risk rises across the board we should expect investors to reallocate in favor of lower-risk assets and away from higher-risk ones. This is necessary if investors are to avoid exceeding their risk budget. So, ironically, the downgrade of US Treasuries may have caused demand for these bonds to soar.³

The Euro-Conundrum

Europe’s festering debt crisis defies any quick resolution. The very root of the problem – merging currencies without merging nations – is also what prevents a clean fix. Collectively, the 17 countries that have adopted the euro have an incentive to ensure the soundness of their common currency. Individually, however, each country has an incentive to “free ride” on the fiscal responsibility of the rest. This phenomenon is sometimes called the “tragedy of the commons.” Greece is probably the worst offender in this regard, with huge budget deficits, massive euro-denominated debts, falsified national accounts, a dysfunctional tax collection system; it goes on.⁴ Greece cannot pay its debts, and there is concern that other euro countries such as Portugal, Ireland and Spain will have similar

² 10-year TIPS now offer a “real” interest rate of almost exactly zero, meaning that one’s return will equal any inflation (more precisely, any change in the CPI) over the period, but nothing more. This is fully 130 basis points below the low point reached in the despair of March 2009.

³ The academic here can’t resist pointing out that this phenomenon resembles the Giffen Good, the economist’s equivalent of a dodo bird sighting, so rare it is. A Giffen Good is one that defies the usual “law of substitution” that as the price of something rises, less of it is consumed. With a Giffen Good, a rise in price so adversely affects the real income of the consumer that it crowds out the consumption of much else. The Irish potato famine of the mid-1800’s is an oft-cited example. The price of wheat in China today may be another.

⁴ I suppose that makes this a Greek tragedy. Ironically, it was the ancient Greeks, Thucydides and Aristotle, who are credited with having first written about the problem.

problems. Even larger pillars of the euro zone such as Italy and France have come under pressure in financial markets recently.

The cost for fixing this mess will be spread across many constituencies, including the citizens and taxpayers of both the stronger and weaker countries, government employees and contractors, and the holders of the debt, most notably the major banks throughout the region. Apportioning the cost among the various players will be an arduous and sometimes frightening process. We cannot rule out another 2008-style global financial crisis arising from a contagious loss of confidence in the region. We are monitoring this situation closely.

Less than Zero – The Cash Headwind

Among the most notable aspects of today's investment landscape is the persistent near-zero rate of interest on cash.⁵ When combined with a positive rate of inflation, estimated at 2%-3%, the result is a negative "real" interest rate. This amounts to a hidden tax on savers through the steady erosion of their purchasing power over time.⁶

In an attempt to shore up confidence last week, the Federal Reserve announced its intention to keep short-term interest rates near zero for another two years. While this action might, through some fairly tortured logic, help the economy a bit, it could not be welcome news to retirees or anyone else living off their portfolio income.

Historically, cash has paid slightly more than inflation. Finance theory talks about stocks and bonds in terms of the "risk premium" of each; that is, the amount of incremental return one might expect to earn in stocks and bonds as compared to risk-free cash. For example, US stocks have earned an average annual return of about 6%-7% above US Treasury bills. With cash now earning a negative real return, even if stocks deliver their historic risk premium, the real (inflation-adjusted) return on stocks could be well below historical norms. The same is true for bonds (and real estate and every other so-called "risk asset"). We view this as an important headwind in today's investment climate.

Volatility and the Long Term

The week of August 8 was among the most volatile on record for the US stock market, with four of the five days registering moves in excess of 4%, and no two consecutive days moving in the same direction. Implied volatility, the so-called "fear index," hit levels not seen since the dark days of October 2008. From our perspective, the stock market looked like a tug-of-war between legitimate

⁵ The Bank of New York recently announced it would charge certain customers to keep money on deposit – in effect, a negative interest rate.

⁶ Compounding this is currency depreciation, another hidden tax. In the last year the US dollar has lost about 15% relative to a basket of foreign currencies, reducing the global purchasing power of dollar holders everywhere.

concerns about the pace of economic growth on the one hand, and potentially compelling stock values on the other.

Here are a few thoughts that we hope will lend some longer-term perspective in the midst of a bumpy ride.

- Volatility, while very unnerving at times, is less important in the context of the longer time horizons of most investors. Investment plans adopted in a deliberate manner, in calmer times, are more likely to achieve long-term objectives than quick decisions made in reaction to patches of high volatility.
- Where is the market going next? We don't know, and neither does anyone else. The only asset whose return we can predict with confidence right now is cash. That return is zero, and considerably less than zero when inflation is factored in. Such is the very high cost of certainty today.
- It is important to distinguish between companies and countries. While the world's mature economies have a long slog ahead, the fortunes of the world's most dynamic companies seem increasingly independent of their legal domiciles. Illinois may be grappling with its own budget deficit amidst a weak regional economy, but McDonalds (of Oak Brook, IL) is probably more focused on growth in Brazil or Malaysia.
- Investors will continue to be buffeted by many factors, including those discussed above. No one can say precisely how these will play out. The only intelligent response to this is diversification among asset classes and, where practical, among investment strategies.

I will conclude on a note of optimism. Every period has its challenges; today is no exception. Everyone likes to talk about the "big picture." In our view, the biggest picture of all is a bright one. The trend toward greater human freedom worldwide is solidly intact. Technology continues to improve living standards across the globe, albeit unevenly. At home, there is a new seriousness of purpose in recognizing that the budget deficit must be tackled, and not only through fiscal adjustment, but through structural changes that can enhance our long-term economic growth.⁷ Each of these portends a better world down the road. For patient investors, this is good news.

⁷ Demolishing our tax code and writing a vastly simpler and fairer one would be an excellent first step.

The entire Gould team is here to help you on the journey. As always, we thank you for entrusting us with the management of your assets.

Yours sincerely,

A handwritten signature in black ink that reads "Donald P. Gould". The signature is written in a cursive style with a large, prominent 'D' at the beginning.

Donald P. Gould
President and Chief Investment Officer

PS – I always welcome any thoughts or questions you may have on this note or on your investments more generally. I can be reached at dgould@gouldasset.com. If you are reading a hard copy of this note and would like to receive an electronic version, just let us know.