September 23, 2011

Market Update

Confidence Wanes

Background

The Federal Reserve's policy announcement this week has further eroded confidence at a time when investors' faith in trusted institutions is already seriously shaken.

Compounding Concerns

Markets run on confidence, with investors depending on governments to pay their debts, policymakers to make needed adjustments, and the financial system to operate without interruption. The simultaneous deterioration of confidence in key institutions has therefore harmed prospects for the global economy and the capital markets. Investors are increasingly concerned about whether the following needed actions will occur:

- European leaders can convince their citizens to accept fiscal union across the euro zone;
- U.S. politicians can agree on comprehensive plans to reduce long-term deficits through spending reductions and tax code changes;
- Banks around the globe can continue to attract the capital they need to operate normally; and
- The Federal Reserve can devise policies that enhance economic growth.

As a result, the economic risks in Europe and the U.S. are escalating. Leading indicators have begun to present patterns that typically accompany the onset of recession; corporate confidence across the globe has softened; and price movements in currencies, credit, and bank stocks suggest deeper distress — exacerbated by leveraged investors pulling back from their prior positions indiscriminately.

The latest disappointment from policymakers was the Federal Reserve's announcement this week of its plans for "Operation Twist." By selling Treasuries with shorter maturities to purchase longer-dated bonds, the Fed hopes to push down long-term yields, stimulate borrowing, and boost economic growth. But with mortgage rates already at record lows, it's hard to see how lower borrowing costs will spur more activity. Moreover, the Fed's policies may actually cut into economic growth: lower long-term yields could crimp banks' profitability and reduce their incentive to increase lending, even as an extended period of near-zero cash yields reduces savers' current income and discourages saving. This week's developments highlighted the Fed's inability to come to investors' rescue. Nonetheless, we can appreciate the diligence and creativity the Fed continues to demonstrate in unprecedented times. We find various politicians' sharp criticisms of the Fed's approach and structure to be an unsettling attack on the central bank's much-needed independence.

Protective Moves

In this difficult environment, we have incorporated significant defensive measures into our investment strategy. For some time, we have held elevated cash levels, which we have raised further recently as economic risks have built. For example, our two large cap portfolios are each holding more than 30% cash, and approximately 50% of the Real Return Fund is in defensive holdings. In our Balanced Growth model portfolio, cash, bonds, currencies, and credit investments stand at a higher-than-normal 48%.

Longer-Term Prospects

Even as the mood darkens, three factors suggest we should retain exposure to growth-oriented assets (including the 40% of Balanced Growth invested in equity and commodity markets, in addition to 12% in hedge funds), which are likely to benefit over time if worst-case economic scenarios miss the mark as we expect.

First, policymakers in Europe and the U.S. face mounting pressure for bolder action to restore fiscal

health. It is rapidly becoming riskier for politicians to do nothing rather than to address problems head-on. Indeed, in recent weeks, key European leaders have explored proposals to increase financial coordination and expand rescue funds for weaker euro-zone members. In the U.S., the Joint Select Committee on Deficit Reduction has commenced its task of identifying $1.5 trillion in deficit cuts by November 23 — with the knowledge that failing to do so will trigger substantial across-the-board reductions. Productive steps from policymakers on both sides of the Atlantic could assuage some of the pervasive uncertainty and spark a gradual recovery of confidence.

Second, the economy appears well prepared to withstand a downturn. Most companies have strong balance sheets, hold reasonable amounts of inventory, and certainly haven't over-hired the last few years. Among consumers, household debt obligations as a percent of income have fallen to their lowest levels in a decade, food and energy prices have moderated, and new unemployment claims remain below crisis levels. Meanwhile, we haven't seen the sudden shocks or tightened policies that normally precede lasting economic downturns.

Third, the environment today is significantly different from the prevailing conditions during the stock market plunge of 2008-2009. Critical differences we see include a U.S. banking system with less leverage, improved housing affordability for the average consumer, and substantially stronger corporate earnings. Global markets have already discounted a lot of bad news in the sharp drop we've seen from their highs earlier this year. From today's starting point of 11 times earnings, stock returns will likely far exceed those of cash and bonds over time.

Our Focus

While we don't foresee a prompt rebound of confidence among companies, consumers, and investors, we believe near-term difficulties will usher in stronger returns over the next several years.

We remain focused on our central mission to preserve and grow our clients' wealth. This requires us to seek to limit losses during market setbacks. Our Balanced Growth portfolio is down about 7½% this year, in line with global stock/bond indexes and far less than the 15% drop in global equity markets. We believe we have positioned client portfolios well for today's difficult market environment. As we monitor developments in the period ahead, we will continue to take appropriate actions and keep you informed.

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