

September 30, 2011

What a Mess!

Economic trouble in Europe and a slowing economy in the U.S. combined to give us the worst quarter for the capital markets since 2008. September marked the fifth consecutive negative month for stocks as investors tried to make sense of the outlook for economic growth. We have said for the past two years that this has been a sluggish expansion, which is why a slowdown is troubling. From this point it would not take much for our economy to fall back into another recession.

The problems in Europe stem from too much debt and the possibility of defaults in Greece. The fear is that a default by Greece would spread to other countries, resulting in massive bank failures. At this point we will need to see a resolution of some sort to this problem for the fear in the markets to subside. This resolution will certainly involve lenders agreeing to take losses of at least 50% with some estimates as high as 70%. In our opinion, the sooner this happens the better off we will be.

In an effort to spur growth in the U.S. economy, the Fed recently announced “Operation Twist” where they will sell U.S. Treasury securities from their balance sheet on the front end of the yield curve and buy Treasuries on the long end. Their goal is to bring down longer term interest rates and flatten the yield curve to create a better environment for borrowing and refinancing outstanding debt. With interest rates at historically low levels it is hard to imagine that lower rates will have much of an impact at this point. Economic fear and uncertainty about the future seem to be the biggest detriments to further investment, and lower interest rates will do nothing to make those fears go away.

Whether we have one or not, the stock market is already pricing in another recession. Valuations for the S&P 500 are 25% below the average level from the last nine recessions. Even with future earnings downgrades expected, the market seems to be expecting the worst. There is so much negativity in the world right now that buyers are staying on the sidelines.

The pullback by the equity markets is the result of new, lowered growth forecasts for earnings based upon these economic conditions. In almost every case the stock market hits its low point well before the economy does. Often, the market begins its rebound before we even know that we are in a recession. This is why we try to keep a long term view of investing and try not to figure out what’s going to happen in the next two months. There are simply too many variables that are unknowable in the short term. As is always the case, good markets happen when we least expect them.

Wabash Capital