

## **Recent Thoughts**

### **July 2010**

For the second quarter of 2010, the S&P 500 stock index returned -11.5%, the Dow Jones Industrial Average returned -9.4%, and the NASDAQ Composite returned -11.8%. The string of positive quarterly results was broken in the second quarter as the market turned in its worst showing since the fourth quarter of 2008. Fears that Europe's debt crisis would spread, disappointing economic data, and the May "Flash Crash" combined to dampen the optimism that had driven stocks higher over the previous four quarters. All ten sectors of the S&P 500 finished the quarter in the red.

The BP oil spill and subsequent efforts to contain the leak captured headlines for the better part of the quarter and ignited a public backlash against the company and its executives. The economic toll on the Gulf coast has been immense as the fishing industry has effectively been shut down, the tourism industry has ground to a halt, and the uncertainty over rules governing off-shore drilling has idled many oil workers. While some progress has been made to contain the leak, it will not be until the relief wells are drilled and the well is permanently capped that full attention can turn to the cleanup efforts. It will likely be some time before the full extent of the environmental damage is known.

Headline inflation has been trending lower this year, while core inflation (excludes food and energy) recently reached a four decade low. Fears of deflation have replaced the risk of inflation, at least in the short-run. Following the onset of the credit crisis in 2008, the Federal Reserve undertook a series of steps to ease monetary policy and ensure the economy had sufficient liquidity to absorb the financial shock. Cutting interest rates to zero and purchasing mortgage-backed securities were two of the more visible policy actions. The enormous amount of money that flowed into the system as a result was the basis upon which fears of inflation were built.

Too much money in the economy generally leads to inflation. However, high levels of unused capacity, elevated unemployment and general uncertainty in the economy have caused money to move much more slowly through the system than anticipated and resulted in lower inflation than originally projected. Inflation may again become an issue when confidence returns and more robust growth resumes. However, for now, the Fed's focus appears to be on fighting the threat of deflation through accommodative monetary policy.

A substantial amount of attention has turned to the budget outlook in Washington. The Congressional Budget Office (CBO) has projected that total government debt will reach 62% of gross domestic product (GDP) by the end of the year, compared to a 40-year average of 36%. Furthermore, under one of the CBO's forecasting scenarios, debt could approach 90% of GDP by 2020. A drop in tax revenues combined with an increase in stimulus spending has resulted in \$1

trillion-plus budget deficits. As Social Security and Medicare are set to account for an ever larger slice of the budget pie, difficult decisions lie ahead for policymakers if they are to put the U.S. on a sustainable fiscal path. While most agree that these decisions will need to be made, there is little agreement on the timing of such decisions.

While those fearing inflation are calling on the Fed to raise interest rates, those who fear that current fiscal policy is unsustainable are calling on Congress and the White House to reduce spending, raise taxes or enact some combination of both. However, others argue just as vociferously that any action taken to tighten fiscal or monetary policy risks derailing the fragile economic recovery that is underway. This is a debate that will likely rage on for some time.

It is looking more likely that the Congressional balance of power will shift, at least somewhat, during the upcoming mid-term elections in November. Political pundits think that Republicans have a chance to gain control of the House and possibly, although at considerably longer odds, the Senate. A shift in the balance of power would have a major impact on legislative activity in Washington. To the extent legislation impacts the financial markets, it is prudent for investors to remain aware of potential changes to our system of checks and balances.

Corporate balance sheets have experienced dramatic improvement recently. Many companies have spent the past couple of years cutting costs and streamlining operations. As a result, U.S. companies currently hold more cash as a percent of assets than any time in the last four decades. A reluctance to deploy cash, pending further evidence of a sustainable recovery, has also contributed to elevated cash levels. As confidence returns to the marketplace, these cash holdings will provide a tremendous opportunity for companies to fund new investments or return cash to shareholders and thus provide a much needed boost to the overall economy.

“Uncertainty” is currently playing a larger than usual role in market performance. It seems that, in nearly all aspects of the economy, there is vast uncertainty which is causing volatility. Whether it is politics, new regulations, inflation / deflation, unemployment, or reluctant corporations, the market is in a temporary “wait and see” mode due to the many unknowns. While the term “uncertainty” carries with it a very abstract definition, there is no doubt the market is suffering from it. Eventually, however, the economy will necessarily need to resume the business of innovation, sales and growth. This time will come.