Market Commentary

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Conference call summary

The current situation

- The U.S. downgrade is not an isolated event, but a continuation of the 2008 financial crisis. It's a consequence of the costs associated with automatic stabilizers, unemployment insurance, stimulus programs, which cost global governments as much as 20% of GDP.
- Now some governments have reached their limits of sustainable debt loads and markets are beginning to insist on fiscal adjustments.
- This marks the beginning of what will be a turbulent social and political period where some of the elements of social safety nets across Western economies are no longer affordable.
- Templates for fiscal adjustment are emerging in peripheral Europe, core Europe, the U.S. and elsewhere. There are going to be lessons from these frontrunners.
- Policy interventions to ease the process of adjustments by governments and consumers are shaping markets more than fundamentals. Examples include the Fed's QE2 and the ECB's intervention in European sovereign bond markets.

Portfolio positioning

- Since April we have had a defensive positioning – incrementally taking cash levels from zero to about 15% in balanced and equity strategies. The funds are about 4%-4.5% gold bullion, underweight equities in the balanced accounts (to less than 50% from over 70%).
- Our emphasis is on large caps that provide liquidity and quality, no small caps.
- We have had a 90% hedge on the euro, a 50% hedge on the U.S. dollar.
- By sector, we are underweight energy and materials and overweight defensive stocks.

Rationale for our conservative positioning

- Last August in Jackson Hole, Bernanke introduced the $600 billion asset purchase program that came to be known as quantitative easing two (QE2). It was aimed at boosting asset prices and confidence, in hopes that a feedback loop from markets into the real economy would foster investment and job formation – and it worked for a while.
- Globally, equities were up 35%. Commodities – everything from grains to energy – were up 40%. Credit markets tightened. Investors moved out the risk curve seeking yield, some bought less liquid and lower-quality assets.

- In our view, prices became inconsistent with the longer-term, low-growth reality that government and consumer deleveraging would mean. That was the principal reason for our move to a more defensive posture.
- A second dimension was that QE2 created inflationary pressures in developing economies, which led to policy responses and a slowing of growth. As a result, the world’s growth engine caught a cold from QE2.
- The third reason is that markets were becoming less resilient to shocks because of financial regulations – Basel III and the Dodd-Frank bill in the U.S. This reduced the capacity of the broker/dealer community to absorb and hold risk, and reduced liquidity in the derivative markets that were used to hedge risks.
- Brokers had to shrink the inventories on their bond desks. This meant that an episode of risk shedding would have a greater impact because liquidity would be low and the prospects of a 50% to 75% retracement from the QE2 rally seemed a likely proposition.
- Along comes this U.S. debt ceiling debate, with lots of fanfare and the downgrade, plus a more significant and immediate issue – which was the spread of the European sovereign contagion to Italy.
- Currently, the EU bailout/bridge loan mechanism is undersized and requires three to four times the scale. That key decision hinges on German willingness to provide regional credit guarantees – something they will only offer once paths to balanced budget are in view in overlevered EU member states.
- These events provided the impetus for the testing of the market liquidity.

Sell-off – but no market meltdown

- We’ve had a sharp sell-off but there are two preconditions for a full market meltdown that do not exist today: widespread leveraged participants and the significant use of short-term funding by market participants, such as corporations and investment banks. In 2008, these led to forced selling and true market meltdowns.
- The traditional leveraged financial participants, the broker/dealer community and the hedge fund community, have little or no leverage at all.
- In the short-term funding market, U.S. commercial paper issuance has been reduced by half and asset-backed commercial paper is completely gone. Corporations have moved to longer-term financing through the bond market.

A longer-term view

- Taking a longer-term view, we have to recognize that this 40-to-50-year cycle of consumer and government debt accumulation, funding extra growth in the developed economies with richer social safety nets, has now run its course. Less generous social safety nets and lower growth lie ahead.
- Markets and policymakers are trying to find a stable pathway to deleverage those two important components of the economy – the government and the consumer – without impacting markets, the banking sector or economies in a profound way.

- In developed markets, a low-growth reality is settling in and capital is migrating to higher-growth, less-indebted emerging economies, where balance sheets for consumers and governments can still expand and support growth.
- This deleveraging in the developed economies is going to take various forms – default, inflation and outright principal paydown. All of them will be employed until a sustainable equilibrium is established in terms of the debt load. The old tools of macroeconomic policy are becoming ineffective. Interest rate cuts are no longer inducing debt-funded consumption or investment to spark recoveries.
- Policymakers are being forced into experimentation with new policies to shape expectations and to influence markets. Ultra-low interest rates will persist until employment and confidence recover.
- It will be a few years of designing the fiscal adjustment that's going to pit taxpayers and lenders against the government welfare state and unions. It's going to be a turbulent time, but that doesn't mean it's unmanageable in all geographies.

Templates are emerging

- The Greek debt rescheduling and principal reductions by holders of Greek bonds being pushed to recognize losses are forming a basis for similar actions elsewhere.
- Templates are emerging from the U.S. debt ceiling debate. The S&P downgrade was market pressure for action.
- These situations will play themselves out time and again – by markets and rating agencies. This isn't the last downgrade.
- The U.S. never really faced a funding crisis. But Italy saw its borrowing costs rise by 200 basis points, cancelled its August bond auctions, and was forced in the space of two weeks to pull together an austerity program and put in place a balanced budget agreement.
- The U.S., as a global reserve currency with the power of its own printing press, is starting to be seen as abusing that privilege. But Italy, which has neither of those options, being a part of a currency union, has been pushed to immediately make responses as a condition of receiving assistance from the rest of Europe, which arrived on Monday with a US$12 billion intervention.

What's going on in financial markets?

- Investment-grade corporate bond spreads moved up 20 basis points to around 120 basis points higher than Treasury bonds; high-yield bonds widened by 100-150 bps to 650-700 bps.
- The commercial mortgage-backed market, leveraged loans, bank credit default swaps are seeing strains. Bank lending is tightening up a bit in Europe.
- Leading up to this, we'd already seen some of the purchasing manager indexes – momentum in manufacturing and jobs – starting to weaken. Meanwhile, the emerging market geographies were trying to cool down to a soft landing.
- GDP estimates are being reduced, some earnings estimates will probably be lowered, but a recession still doesn't look likely.

- The policy apparatus is more advanced. Mechanisms needed to support the banking sector are in place. The rest of the globe has “derisked” in relation to short-term funding and has become much more conservative over the last three years.
- September will tell whether this is a summer *quakelet* – or if it’s part of a bigger shutdown. We believe that financial markets are not going to shut down and that this is an appropriate repricing of risk.
- Bond spreads had been pushed too tight, so a widening of spreads is good, particularly for our yield-seeking strategies.
- Equity markets may have overreacted, but a reset was needed.

Investment implications

- It means lower rates, for longer, in the developed economies. Investors who are seeking yield will still have that problem.
- So long as there’s not an outright recession, it’s a supportive environment for credit.
- On the equity side, companies with 11 or 12 times P/Es, strong balance sheets, rising dividends look appealing. One word of caution, fundamentally this is a margin squeeze as consumers facing stagflation in developed economies trade down.
- Refugees from riskier sovereign bond markets or economies are going to continue to flood into the fiscally sound geographies – Canadian dollars, Swiss francs and the Aussie dollar – and this is going to manifest itself in low interest rates here.
- In terms of foreign exchange markets, further U.S. dollar weakness is part of the strategy to restore competitiveness, attract foreign direct investment and to sponsor employment. All those things will keep money looking for alternatives to the U.S. dollar.
- Commodities are a similar story to the ongoing U.S. dollar pressure. I think that commodities will have higher floors because they are valued in U.S. dollar terms. This is clearly evident in the gold market, and will be verified in the oil and property markets, as investors look at real assets as stores of value.
- In emerging market equities, valuations are now low. We think that there’s durability in the emerging economy growth cycle, and even if they try to cool things down, everything that’s gone on in the last few months makes them more inclined to sponsor growth. We believe long-term growth is intact in emerging markets.
- Our baseline case is that income strategies will continue to work and so will equities of high-quality companies with dividends.