Cornerstone Financial Management LLC
August 9, 2011

Global Financial Markets in Turmoil

Dear Clients and Friends,

During the last two weeks, the global financial markets have experienced tremendous volatility that is reminiscent of the Financial Crisis in the fall of 2008. I understand that sharp market declines can be stressful and worrisome, so I thought it would be helpful to share the following perspective about what has been taking place and how it impacts my investment process. Here is a brief review of the key events that appear to be at the heart of the recent swift downturn.

The Process of Raising the U.S. Debt Ceiling

At what seemed like the very last minute, the U.S. House of Representatives and the Senate agreed on a compromise plan to increase the U.S. Debt Ceiling, and the President signed the legislation into law on August 2, 2011. The plan will allow the federal government to borrow additional money to fund its budget deficits through December 2012 (after the next presidential election) in exchange for reductions in the projected rate of increase in federal spending. While participants in the financial markets were relieved that the debt ceiling was raised, the process by which it happened sapped the confidence of investors, not only in the U.S. but around the world. This was a contributing factor for the sell off in U.S. stocks during the last week of July.

The Continuing European Sovereign Debt Crisis and Banking System Stability

As we have written many times during the last year, there has been an ongoing financial crisis in the so-called GIPSI countries (Greece, Ireland, Portugal, Spain, and Italy) at the periphery of the European continent regarding government debt and fiscal deficits (government spending greater than tax revenues). Rescue plans have been assembled to allow Greece (twice) and Ireland (once) to continue to borrow money rather than default on their existing government debt. During July, government bond yields in Portugal, Spain, and Italy rose to levels at which Greece and Ireland required financial assistance, leading many market observers to predict that rescue plans would have to be put in place for these countries as well. Last Thursday, August 4th, the European Central Bank gave conflicting messages about how they were planning to deal with the crisis and investors panicked. European government bond prices fell sharply and bond yields spiked upward, endangering many of the commercial banks in Europe that own these government bonds. This was a contributing factor in the sharp decline of stock prices around the world last Thursday. The European Central Bank announced on Monday, August 8th, that it will purchase Spanish and Italian government bonds in an attempt to drive bond yields down and permit these countries to borrow additional money at lower interest rates. In return, governments must cut spending, attempt to balance their budgets, and promote deregulation of their economies to boost economic growth. At this time, it is not clear whether this plan will be successful in arresting the "contagion" and bolstering the balance sheets of European commercial banks so that they are not in danger.

Evidence that U.S. Economic Growth is Unexpectedly Slowing

On Friday, July 29, 2011, the U.S. Commerce Department released its "flash" estimate of growth for U.S. GDP (Gross Domestic Product) for the second quarter of 2011. The U.S. economy is estimated to have grown at a rate of 1.3%, much slower than the 2% or higher rate most economists had been expecting. In addition, the growth rate for the first quarter of 2011 was revised significantly downward to 0.4%, from the previously reported figure of 1.9%. Severe winter weather, the spike in oil and gasoline prices, and the supply disruptions resulting from the Japanese earthquake and tsunami in March are generally thought to be the cause of the weaker than expected GDP growth figures for the first half of this year. Whatever the reasons, it is abundantly clear that the U.S. economy is barely growing fast enough to avoid falling back into recession, much less growing fast enough to significantly reduce the high rate of unemployment.

Furthermore, economic data for the 2007-2009 U.S. recession were revised to show that the downturn was deeper than previously thought, and the recovery since mid-2009 has been less vigorous than previously reported. Finally, real incomes (personal income after inflation has been taken into account) have been falling for most workers that have been blessed to have jobs since the recovery began over two years ago, further dampening final demand for goods and services and the rate of economic recovery.

The Downgrade of the U.S. Government's Credit Rating by Standard & Poor's

After the financial markets closed on Friday, August 5th, Standard & Poor's (S&P) downgraded the debt of the United States from its highest rating, AAA, to its second highest rating, AA+. While politicians and pundits spent the weekend trying to assign blame for the downgrade, it should not have been a surprise given what S&P had telegraphed back in the spring of this year and the fiscal projections from the non-partisan Congressional Budget Office for the 2011-2020 period. S&P blamed the downgrade in part on political gridlock in Washington D.C., while China bluntly criticized the U.S. government for its "debt addiction." U.S. government spending is now at an historic high of 25% of GDP, and U.S. government debt is approaching 100% of annual GDP, a level of debt at which a study of economic history has shown slows the future rate of economic growth.

The Current Investment Environment and Investment Strategy

U.S. large cap stocks as represented by the S&P 500 Index fell over 18% from the most recent peak on Friday, July 22nd through Monday, August 8th. More volatile U.S. mid cap, U.S. small cap, and foreign stocks generally posted deeper losses. Meanwhile, U.S. Treasury bonds have rallied strongly because of the flight to (perceived) safety of U.S. government debt (in spite of the credit downgrade!). While the stock market rebounded by 4-6% today (August 9, 2011) we don't subscribe to the idea that this is the "all-clear signal" to get back into stocks.

It is very apparent that economic growth in the developed world, including North America, Europe, Japan, and Australia, is very close to "stall speed," and that the developed economies could fall back into recession, particularly if there is a policy error on the part of central bankers and/or politicians. While economic growth in the emerging economies is quite robust compared to the developed economies, the largest and fastest growing countries of China, India, and Brazil have been implementing policy steps to slow down their growth rates and moderate inflation rates that are running more than twice the rate of inflation in the U.S. Government bond yields in Brazil are currently inverted (short-term yields are higher than long-term yields), which often precedes a significant economic slow down or recession, and India and China are raising interest rates and tightening bank reserve requirements to cool down inflation that is in excess of 7%. The risk is that growth in emerging economies will slow significantly, leading to a global slow down or recession. With the European Central Bank still in denial about the state of economic growth and the debt situation in the Eurozone, only the U.S. Federal Reserve Bank has policies in place that are anywhere remotely encouraging economic growth. The result is an asymmetric risk-reward environment, with considerably more downside risk than upside potential.

Therefore, we are maintaining our defensive and cautious stance on stocks and other "risk" assets that we wrote about in our first quarter letter this past spring. We have also raised cash during the last two weeks, primarily by selling higher risk stock funds. We are emphasizing lower risk and higher dividend paying stock funds that should outperform in a down or sideways stock market. If the stock market rallies sharply, we will not keep pace, but we are willing to underperform in that environment given the headwinds we are currently facing. If the stock market sells off further, we may consider adding to stocks if valuations begin to look compelling.

I understand that watching a sharp market decline in a few weeks or months is very stressful and unsettling. We will continue to be vigilant and monitor events for you. If you have specific questions or concerns about your investment portfolio, please give me a call or send me an email. I wish you a good and relaxing remainder of the summer season.

Best Regards,

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