

Economic Conditions & Market Outlook

When our previous *Investment Update* was distributed on the first business day of May, it noted that ‘muted market volatility’ and ‘paced appreciation’ had been the norm since a brief market sell off earlier in the year. Three weeks later, ‘muted’ and ‘paced’ are hardly the adjectives one would use to describe recent market movements. Huge swings in stock prices have been a daily occurrence and the market’s trajectory has been decidedly downward.

The U. S. stock market did bounce back a bit on Friday; with the Dow Jones Industrial Average, the Standard & Poor 500, and the Nasdaq each closing up 1.25%, 1.50%, and 1.14% respectively for the day. But the net trend of the three indices for the month is still negative and all are hovering near a 10% correction level decline from the 2010 highs that were reached during the last week of April. Several developments since the beginning of the month contributed to this notable shift in investor sentiment.

First, market focus on Europe’s sovereign debt problems grew increasingly fretful during the first few weeks of May. After the approval of a \$1 trillion bailout commitment via the combined resources of the European Union and International Monetary Fund, investors were initially relieved. In reality, this massive package is more than sufficient to remedy the current woes of Greece and several of their spendy European neighbors. But concern soon resurfaced regarding the long term economic sustainability of the euro zone alliance if continually weighed down by the burdensome public debt and lack of political will needed to curb spending among its most profligate members. When coupled with the flagging value of its common currency and an already less-than-robust recovery on that side of the Atlantic, worldwide markets became increasingly jittery.

While wrestling with this issue, a second factor rattled the markets when on Thursday, May 6th the Dow Jones Industrial Average plunged over 1,000 points from its high of the day, the largest intraday point drop ever. A partial rebound soon ensued, with the index closing down about 348 points (-3.2%) but the harrowing ride understandably unnerved investors at all levels. Reasons proffered for starting the brief but heart-stopping plummet initially ranged from human error to a complex computer glitch to some indeterminate conspiracy. While most of these have been eliminated as the impetus, no single cause has been identified as starting the avalanche of computer generated sell orders that drove the market down. It will likely be determined to have been caused by a combination of rapid-fire, technologically-driven events that crossed unexpected thresholds not previously protected by so-called trading circuit breakers. Undoubtedly, the cause/cure of the ‘flash crash’ will be found and corrected but the fact that it has not been yet still hangs over the markets.

Despite the Securities and Exchange Commission likely already having both the power and tools necessary to formulate a solution, it would not be surprising for Capitol Hill to attempt to unilaterally legislate some remedy before fully understanding the problem. This is a third factor that has weighed heavy on the markets during early May; dread over what draconian measures a populist-posturing Administration and Congress intent on painting Main Street as victims and Wall Street as villains might place in their rendition of financial regulatory reform. Markets eschew uncertainty and some of Friday’s bounce, particularly in the financial stocks, came from at least knowing what the Senate’s version of the bill entailed after its passage late Thursday afternoon.

This firm has long argued that financial reform and increased regulation was needed in several key areas, such as enhancing transparency/disclosure for investors, improving market efficiency/safeguards, reducing the limits of trading leverage by commercial banking institutions...just to name a few. While the bill passed nods toward some of these critical concerns, it too often misses the mark.

Broader authority to intervene in troubled institutions having systemic risk potential, increased supervision of hedge fund activity, reducing rating agency conflicts of interest and improved shareholder input on certain corporate governance matters are all positives.

But Congress' narrow understanding of normal market functionality, tinged with a hint of retribution towards this Administration's definition of 'evil-doers', has raised certain bank capital requirements and limited the ability of these firms to hedge necessary internal business risks, despite *strong* recommendations to the contrary by the Federal Reserve, the U.S. Treasury Department, and the FDIC. Conversely, in spite of Freddie Mac's and Fannie Mae's mismanagement (with Congress' tacit approval) having a leading role in the events that eventually contributed to the mortgage meltdown, the bill makes no attempt to address or correct these problems and the organizations' ongoing billion dollar drain of U.S. taxpayer dollars. Similarly, while the bill touts the formation of a far-reaching Consumer Financial Protection Bureau, it turns a blind-eye to resolving the longstanding issue of holding broker-dealers who purport to give investment advice accountable to the same high fiduciary standards required by the SEC of its registered investment advisers.

In spite of these shortcomings, the market prefers the devil it knows as opposed to the devil it doesn't, so the increased clarity of knowing this bill's content should help mitigate some of the recent uncertainty-induced volatility. However, the same cannot be said about the situation in Europe. While immediate fear of an impending default on Greece's debt has been averted, concerns regarding the long term health of the European economies and the sustainability of their recoveries will linger and may continue to roil the markets throughout the summer. Likewise, the perceived less-than-business-friendly attitude emanating from our nation's capitol coupled with the current rush-to-legislate mindset may also continue to dampen investor enthusiasm near term.

There are also many factors we see as being quite positive at present. Many fundamentals influencing the investment markets, from corporate earnings to economic metrics, continue to improve. From a technical perspective, the market appear to be oversold and the correction that many market watchers have been longing for has indeed occurred, potentially providing the base for the next market leg up. In the long-term, we remain very bullish as to the upward direction of both stocks in general and the economy as a whole. But the potential for continued near-term volatility and the market's current preoccupation with the negative has prompted us to pare equity exposure across the board until some semblance of stability returns. This may occur be sooner as opposed to later but until that time a few of the tactics currently being used to reduce portfolio risk and optimize portfolio performance given present market conditions are outlined below:

- The *overall target level* for portfolio allocations has been reduced to the *one-step below midpoint equity* level based on each client's individual investment policy range. This target level was previously held at close to *maximum equity* and was *quickly reduced* in response to *increased market instability*. We continue to see the *relative risk/return* potential in the equities asset class as being *more attractive long term* than either bonds or cash but there appears to be *greater potential* for continued *unpredictable volatility near term*. Specific steps for returning to a higher level of equity exposure are already being formulated.
- *Direct foreign equity* exposure had already been *previously pared* but *additional reductions* were made in investments that would be *potentially adversely affected* by continued European problems, at either the economic or currency level. Likewise, mutual or exchange traded fund investments that maintained concentrated exposure in the broader market segments *most impacted* by the recent volatility, such as *Energy and Financials*, were *reduced first and to a greater degree*. The firm's ongoing *sell discipline* also targeted and emphasized specific investment areas where *profits could be preserved*. Despite the reduction in overall equity exposure and the specific focus on certain sectors, *portfolio diversification remains a priority*.
- *Short-term fixed income* levels will likely be *significantly above the norm* during the near term due to the *temporary and tactical retreat* from higher equity exposure. The ability to have adequate *portfolio liquidity* available for *potential rapid redeployment into equities* is worth the short term tradeoff in lower yields. If higher than acceptable risk continues to accompany the equity markets, some of this disproportionate cash exposure will be redirected into higher yielding fixed income investments.

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