RBC Wealth Management™

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"Shark Infested Waters"

I'd like to start with an email question received early this week:

"Clearly, the U.S. and global economies are still fragile, investors' psyches even more so. Market volatility has not only been exhausting to investors, but also more confusing then ever, e.g. the debt ceiling was raised and the market plummeted, US debt was downgraded and treasuries rallied. Since the 2008/2009 market crash, you have consistently remained optimistic on the economy and equity markets. Is there a scenario (or scenarios) that you can think of that would have you rethink your position? What in your mind are the greatest risks to the ongoing recovery? "

When I review my writing and seminar topics from the last three years a clear theme resonates: there has been a great struggle with the negative psychology resulting from the crisis environment caused by the housing, credit and leverage induced recession of 2008/09. The titles of my commentaries have included : "From Irrational Exuberance to Panicked Pessimism: How Did We get Here and What Do We Do Now" written in October of 2008; "The Case for Optimism" used many times beginning in March of 2009; "Markets Testing Conviction" on multiple occasions; "The Markets are a Mean, Sadistic Beast"; "Déjà vu All Over Again"; "Keeping Disaster in Perspective"; "Flight to Safety"; - all intended to be proactive and forward looking, but revolving around the concept of fear creating opportunity. However, that opportunity, seen through the eyes of a value investor, has not necessarily helped clients sleep well at night in a constantly shifting, volatile market environment. Throughout this time there have been sharply divided camps: with those like Nouriel Roubini and Meredith Whitney constantly warning us to "Stay Out of the Water it's Full of Voracious Sharks " while other's like Warren Buffet have spoken calmly about America's ability to reinvent itself, normalizing economic conditions and long term investing opportunities - Buffett has consistently said "Come on in the Water is Fine!" Meanwhile, CNBC and other media outlet's vacillate wildly between the two possibilities and the 24 hour news cycle is baffling to those trying to find the middle ground and a sensible path forward.

Let's start with a few key data points:

- The US has a debt problem along with many other developed countries
- Total public debt outstanding equals 100% of gdp. However, if you exclude the debt held by the Fed ($2.7 trillion) and other intragovernmental agencies (like the Social Security Trust Fund) debt to gdp is 69%. To put this in context, at the end of WW II debt/gdp exceeded 100%.
- Sometimes recessions are ended by war (depression/WW II) and sometimes they are started by war (war on terror/2008-09) .
- US credit rating was recently downgrade by S&P to AA+ from AAA
- Downgrade is a political event largely related to the brinksmanship of the recent debt

ceiling debate and won't have much impact on borrowing costs . S&P made a $2 trillion math error in their assumptions - when this was pointed out to them, they changed the rationale of their downgrade from an economic one to one centered on political risk.

- The two other largest economies in the world have lower ratings. China is rated AA-, Japan AA-
- US debt to gdp lower than France and the UK who have maintained AAA ratings.
- The cost of servicing the US debt is the lowest in history at 1.4% due to low interest rates.
- Debt ceiling has been raised 70 times since 1960.
- Fitch reaffirmed their AAA rating saying the "key pillars of the US's exceptional creditworthiness remain intact." Moody's reaffirmed their top rating last week.
- Deficit issue is: between 2001-2009 spending increased by 6.5% of gdp from 19.2% to 24.7% while taxes declined 4/7% from 19.5% to 14.8%. Meanwhile, entitlement spending grew by 5% per year (Medicare/Medicaid is 22% of government spending, SS 19%, Unemployment and other entitlements 17%, Defense 19%, Interest Payments 6%, other discretionary spending 18% (1/2 of which ends up going to defense currently).
- Government currently funded 67% by revenues, 33% by borrowed funds.
- Outlays too big, receipts too small.
- In order to lower debt to gdp to 70% (from 100% including government owned debt) over the next decade we need total deficit spending reduced by $5 trillion, to get to 60% we need to cut the cumulative deficit by $7.5 trillion.
- A balanced budget now risks recession just as it did in 1937, therefore the austerity needs to be back end loaded.
- 68% of American's support tax increases on income over $250,000 while only 19% say they support only spending cuts.
- If the Bush tax cuts from 2001/2002 are allowed to expire at the end of 2012 that would save $4 trillion over the next decade.
- A 10% federal sales tax phased in over the next 10 years would raise $5 trillion in revenue. This is a very common tax in other nations and could mitigate the need to raise corporate and individual taxes. This could also help by preventing corporations from shifting profits overseas to avoid US taxes thus stimulating investment and growth.
- Defense costs (about $1.3 trillion - $862 billion directly and the rest from discretionary spending - in 2010) will fall as Afghanistan and Iraq wind down.
- Social Security is currently self funding, but will go into deficit - the problem is when implemented it allowed benefits at age 65 and the average American lived to 64. Now the average lifespan is 77+. Possible solution, raise the age when benefits are paid or create an income cap.
- Fed has said they will keep the fed funds rate low at least through mid-2013 indicating low growth expectations.
- I believe the probability of US recession is less than 35%. This is based primarily on the fact that corporate fundamentals - earnings, revenues, balance sheet strength, capacity to increase dividends, buy in stock and make acquisitions - are very strong. Leading Economic Indicators including ISM data regarding growth in manufacturing continue to indicate economic expansion albeit at a lower rate than just several months ago. This is affirmed by industrial production and capacity utilization data which also shows improvement. Also, the yield curve remains relatively steep - it has always inverted prior to a recession since the second world war. Generally, housing starts also fall sharply and unemployment rises prior to a new recession. Giving how low starts are and

how high unemployment is those may not be the best indicators right now. Rail and truck shipments remain strong indicating end demand is good.

- The 10 year treasury currently yields less than 2% while it has averaged 6.67% over the last 50 years.
- Expectations are exceptionally low which is why the S&P is trading at 11.3 X this years earnings while compared to an average of 16X for the last 50 years and 19X when inflation is 2%.
- The S&P 500 yield of 2.3% is higher than the10 year treasury.
- If we get a recession resulting in S&P earnings dropping 10% from 2011 estimates of $100 and you put a 10X earnings multiple on that number that could result in the S&P falling to 900 22 % below current levels. If we avoid recession and you put a lower than normal multiple of 15X 2012 forecast earnings of $112 that could lead the S&P to a level of 1,650 over the next year for a gain of 44%.
- The importance of assessing your time horizon and risk tolerance is being tested. This means asset allocation is more important than ever.
- Unemployment remains stubbornly high at 9.1%. If it does not begin to decline substantially, meaning to below 8% by the end of 2012, the economy will have difficulty achieving historic growth rates of 3% or so.
- Over the last 2 weeks 65% of market volume has been high frequency trading vs. an average of 26% in 2006 - this creates a tremendous amount of short term volatility. Reinstating the uptick rule would tame this.

If, over the next several months, corporate profits and revenues slow sharply and, particularly, if they shrink, or gdp seems likely to turn negative (ie recession), or the yield curve flattens or inverts, that would cause me to go into a defensive mode. I look to Leading Economic Indicator's (LEI's), ISM manufacturing and non-manufacturing data, construction starts, capacity utilization (77.5% July vs. upwardly revised 76.5% June), industrial output (which in July grew the fastest in 7 months +. 6 %) to forwarn me of the possibility that any of these events are likely/probable.

In summation, corporate and economic fundamentals do not seem to warrant fears of a new recession and therefore the market and many individual securities are attractively valued with a long term outlook. I believe the panic and high volatility of the current environment will recede in coming months and advocate patience.

Regards,

Terry