WealthHealth
Personal Wealth Management

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After a buoyant start to the year, US markets sustained a six week slide that showed no signs of relenting until mid-June, setting up a summer of stock trading likely to be dominated by gyrating commodity prices, US growth concerns and European sovereign debt fears. Momentum that carried stocks higher through the first four months of the year fizzled in May as investors became increasingly concerned about a slowing economy (exacerbated by supply chain interruptions stemming from the Japan earthquake) and fears that a Greek default would spread contagion to other weak European Union (EU) members and rattle the European and even global financial systems. Those concerns, particularly relating to Greece, intensified as the second quarter progressed, and a modest retreat in May worsened in June before we saw a late-month rebound as it became increasingly likely that the EU and International Monetary Fund (IMF) would manage to kick Greece's debt can down the road at least one more time.

When the dust settled, stocks wound up roughly flat for the quarter. Large-cap U.S. stocks measured by the S&P 500 index were flat while smaller-cap stocks lost 1.6%. Growth did better than value. The Barclays Capital US Aggregate Bond Index gained 2.29% for the quarter as investors sought refuge in lower-risk assets. It was a quarter of risk-on, risk-off trading, familiarly known as beta trading. Looking abroad, developed-market foreign stocks gained 1.56%, while emerging-markets equities fell 1%. Local-currency emerging-markets bonds had a strong quarter, gaining 4%.

Index Returns *Through 6/30/2011*

			Annualized Returns		
Index	QTD	YTD	1-Year	3-Year	5-Year
S&P 500	0.10%	6.02%	30.69%	3.34%	2.94%
Russell 1000	0.12%	6.37%	31.94%	3.68%	3.30%
Russell 2000	-1.61%	6.21%	37.41%	7.77%	4.08%
MSCI EAFE	1.56%	4.98%	30.36%	-1.77%	1.48%
Barclay Capital US Aggregate Bond	2.29%	2.72%	3.90%	6.46%	6.52%
Barclay Capital Municipals	3.89%	4.42%	3.48%	5.58%	4.93%
Dow Jones AIG Commodity	-6.73%	-2.58%	25.91%	-11.87%	-0.05%
HFRI Fund of Funds Composite Index	-1.21%	-0.33%	6.65%	-1.82%	1.53%

Our View

There are a handful of important points that underlie how we view the world in general and the investment landscape in particular. We have cautioned that our underweight to equities makes it likely we would under perform in a rising market, as was the case starting in the fourth quarter of 2010 and into this year. In the more recent downturn, our portfolios have held up better, as we also would expect. We have reduced stock allocations across the board in favor of tactical allocations to flexible fixed income, arbitrage, and emerging-markets bonds. These positions are less risky than stocks but generally provide less short-term downside protection in the event of an economic slowdown than core high-quality bonds. The net result is that they reduce overall portfolio risk.

First, we continue to see potentially serious risks out there that could be damaging to the investment markets. The range of outcomes in terms of the global economy is very wide and some of the negative outcomes, while lower probability, could be quite severe.

A number of major problems have been weighing on the markets.

A Greek default is a significant concern, particularly the risk of contagion spreading to the other weak EU countries and the broader financial system.

We are increasingly concerned that China could face a "hard landing" for its economy.

At home, the debt/deficit problem is significant and we probably have only a few years before borrowers start demanding higher rates for the risk of lending to a fiscally challenged U.S.

Given the wide range of potential outcomes, which are skewed to the downside, we remain underweighted to equities and overweighted to non-traditional, lower-risk asset classes.

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One such possibility is that of a Greek default, but there are other significant risks as well including the chance that China sees a sharp slowdown that affects the global economy, our own debt problems (both at the household and government level), and ongoing weakness in the economy highlighted by persistent weakness in jobs and housing. These issues matter because they have the potential to roil markets and, in a bad-case outcome, cause significant losses. Regardless of the magnitude of the losses, if any, these risks pose a strong likelihood that it will be harder for the economy to grow at a normal pace in the years ahead.

Second, it is especially difficult to predict how these global and domestic issues will unfold in the years ahead because complexity is so high. The future growth of the world economy boils down to how investors will react to the Federal Reserve's ending of the second round of quantitative easing (QE) which ended on June 30, the EU's and IMF's (IMF) involvement with the debt crisis which, as we write this letter, has not only has been focused on Greece but now has Italy in the spotlight, and whether the US government can agree to raise its debt ceiling before August 2nd so as to avoid any defaults on its lending and the dramatic effects such an outcome would have on the markets and the US dollar. More recently, Chairman Bernanke has eluded to the openness of the Federal Reserve to consider such a third round of QE should it be necessary. As eluded to above, the rise of inflation in the emerging markets (China, Brazil and India) has also raised concern over a slowdown in world demand as interest rates have begun to rise in those economies. Based on these complexities and potentially other unforeseen shocks to the markets (like the Japan earthquake) we think that there is more downside in a bad outcome than there is upside in a good outcome.

This brings us to our third takeaway, which is that stocks and other risky assets aren't priced cheaply enough to reward us adequately for the risks we see. Meanwhile, we believe we can get similar or better returns with less volatility and less downside from other investments that we own, like flexible bond and absolute return strategies, which don't depend on tailwinds from rising markets to earn their returns. The net of this is that our portfolios are conservatively positioned at this time and we expect this to continue until we see better return potential from riskier assets.

Finally, in terms of setting expectations, markets could continue to climb in the short term. Very low interest rates encourage investors to take on risk and, as time passes, can contribute to complacency. But time won't fix the problems such as our federal deficit or Greece's unsustainable debt load. These problems will either come to a head on their own, or actions will be taken to fix the problems—either course will result in pain. If we do see markets get roiled, we will be prepared to take on more risk at levels that promise better returns. In the meantime we will probably lag in a rising market, which brings up a different kind of risk—the risk of being "wrong" in the short term. To that point, our process is one that demands we make decisions based on analysis of longer-term factors, which we can do with much higher confidence. Predicting the short term is not something we believe anyone can do reliably and consistently.

Greek Debt Crisis Fears (Again)
It appears that the European Union, the European Central Bank, and the IMF will once again provide Greece with additional financial assistance (i.e., loans at below-market interest rates) in return for Greek promises of more fiscal austerity. The aim is to buy more time with the hope that Greece will ultimately be able to get its fiscal house in order and pay back the debt. However, we, and most other investors, believe some type of Greek default or "restructuring" or "reprofiling"—in which the debt repayment schedule is extended but the principal value is not marked down—is inevitable given the severity of their situation.

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As one investment strategist put it, "Everyone knows Greece will default—it's just a question of whether it's orderly or disorderly."

Given the very high likelihood of some form of default, the key question for us and our investment managers is in regards to the timing and, most importantly, the impact on the global economy and financial and credit markets. Unfortunately, the answers to these questions remain highly uncertain at this point, but potentially quite severe.

By itself, a Greek default is probably manageable for the global financial system without causing a crisis—although even that is not certain given the global financial system inter-linkages. However, the big risk is that a Greek default could spiral into a broader European debt "contagion" spreading to other heavily indebted European countries, such as Ireland and Portugal and possibly even Spain or Italy. Even if these other countries don't want to default, there could be a "run on the banks" that basically forces default in a self-fulfilling prophecy—the market refuses to lend to these countries, therefore they can't roll over their debt, therefore they default unless the central banks and the IMF can come up with enough financial support to restore confidence and stop the bank run before the financial system is overwhelmed.

Greece remains a rapidly evolving situation, as does Italy. We continue to analyze the potential outcomes in terms of their likelihood and magnitude of impact on the asset classes in which we invest. Should there be a crisis in the near-term related to Greek debt, we'd expect Treasury yields to fall (and therefore Treasury prices to rise) and "risk assets," such as stocks and emerging-market currencies, to fall. Treasury bonds are still perceived as a "safe haven" asset class—despite the United States' own debt problems.

China Hard Landing

Another risk that we have highlighted recently and that is growing in importance in our macro assessment is a potential "hard landing" for the Chinese economy (as opposed to a smooth manageable slowdown) and the global ripple effects that would result. Most international managers agree that there is a bubble in at least some segments of China's property market. The general consensus is that this bubble is not widespread and can be managed by the Chinese government, as it has been in the past. There is a risk, however, that the bubble may have already grown very big and, if pricked, will result in a sharp contraction for China. A hard landing will be negative for equities, commodities, and also for our allocation to emerging-markets local-currency bonds. We have talked to and read analysis of both the optimists and the pessimists, and it is hard to really know who is right.

The U.S. Economy Is Slowing Again

Recent U.S. economic news has been disappointing, with sluggish GDP growth and continued weakness in employment and housing (which are important drivers of consumer confidence, income, and spending). On the jobs front, the latest employment report for May and June showed growth in nonfarm payrolls of only 54,000 and 18,000 respectively, a big drop from the 220,000 monthly average increases in the prior three months. We have seen estimates (from various economists) that the economy must create anywhere between 100,000 and 200,000 net, new jobs each month just to absorb the natural flow of new entrants into the labor force and keep the unemployment rate flat. More recently, the unemployment rate in June ticked up to 9.2%. Meanwhile, private and government economists have been cutting their growth forecasts for the year to below 2.5%–3% in most cases.

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What Would Lead Us to Become More Optimistic?

We are occasionally asked what would lead us to increase our equity exposure or become more optimistic about the macro environment. In terms of increasing our equity exposure, first and foremost would be an improvement in market valuations, which would raise our return expectations for stocks over our investment analysis horizon. All else equal, a drop in stock prices improves the expected future return.

Alternatively, if our assessment of the economic fundamentals and, in turn, corporate earnings growth materially improves while stock prices remain flat, that could also lead us to increase our exposure to equities based on higher expected returns. Credible and concrete policy actions to control the United States' long-term structural budget deficit and evidence of successful deleveraging among the public and private sectors would be additional fundamental factors that could lead us to shift our scenario assessment to a more positive range of outcomes for riskier assets.

A Concluding Reminder About Downside Risk

Having said what could turn us more positive, we will conclude with a reminder about the potentially severe downside, e.g., in the event of a European debt contagion, China hard landing, or some unexpected systemic shock. In that event, we'd expect riskier assets to depreciate. Although we don't manage our portfolios to a worst-case scenario because the opportunity cost from foregone returns in the event less-dire scenarios play out can be significant, it is certainly possible that the downside for equities is more severe than we assume. Along the way, if we see risk increase but stocks not yet reflect it, we could further reduce equities. We also expect that periods of fear will give us the chance to increase equity allocation at more attractive prices.

The good news for clients is that we have uniquely allocated each client's portfolio to that of their appropriate level of risk, based not only on emotional factors but on financial needs analysis and modeling as well. As a result, in the event of a severe market downturn, our relatively defensive positioning should enable us to redeploy capital from lower-risk investments into equities or other higher-risk assets with (at that point) much better return potential. As we've written in our past commentaries, if there is one thing we can be almost certain of, it is that there will be market shocks over the next few years and they will create investment opportunities for us to take advantage of. There may also be events that magnify risks that we will want to further protect against. In either case, we will continue to invest based on where our research and analysis leads us, not based on what the investment herds are doing, "common industry practice," or anything else of that nature. We are alertly watching this complex environment and are prepared to act quickly when and if it makes sense to do so.