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## Weathering the Volatility

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The first few weeks of August for the stock market have represented a rapid flight from risk. The third-quarter bounce for the economy, driven by the tight consensus of investors three weeks ago, has now been completely rejected by the capital markets which have turned lower, despite the fact that earnings remain robust for Corporate America. The market has also ignored several recent, solid assessments of the economy, especially the recently released employment report, which showed a welcomed gain of 154,000 jobs being created in the private sector for July. The uncertainty of the European debt crisis, the intense debate on the U.S. debt ceiling and the S&P's downgrade of U.S. Treasuries precludes any material hope of fiscal or monetary stimulus before the next election. This lack of policy actions has increased the perceived risk in the markets that is causing investors to flee. **In a sense, "all news has been bad news" as of late.** I have often written about differentiating between the media's "headline" risk and fundamentals.

European issues are challenging to say the least, but not a crisis. The news flow makes it sound like Europe is flailing about trying to throw more money at a growing problem. European Central Bank President Jean-Claude Trichet's statement this week—that the downside risks to growth have intensified and that they will let banks borrow as much as they need—had an air of desperation to them. But, I do not believe the situation is nearly as bad as the headlines make it seem. The likelihood of a Greece-like situation developing is remote for the market's next perceived "problem child": Italy. Unlike in Greece, substantial spending cuts are already well underway in Italy. Italy has already cut government workers, raised revenue by eliminating some tax breaks, and sold government assets, which is moving the country on a credible path to fiscal sustainability. In fact, in 2010, Italy reduced its deficit-to-GDP ratio by nearly a percentage point and has a lessor debt burden than does the United States, Japan, and the United Kingdom.

To be sure, some recent economic data has been disappointing, notably the downward revision of second quarter gross domestic product (GDP) and the July ISM Purchasing Managers' Survey which showed elements of manufacturing activity down near contraction levels of 50. However, it has not been all bad of late as retail sales continue to post strong advances, weekly unemployment claims dropped back to the all-important 400,000 level, housing starts showed modest signs of improvement, and employment accelerated dramatically in July relative to the previous two months. The bottom line is that the economic data is mixed, but not terrible. We still see below-average growth on tap, as we forecasted for this year, but we do not see a double-dip recession on the horizon at this time.

With bond yields falling as investors flock to the safe-haven of Treasuries and major stock market averages now down about 10% from the recent highs; this may seem all too familiar. It is natural to wonder about how recent economic conditions compare to those of 2008 and if the market is foreshadowing that another crisis is on tap. The message from the markets is important, but in last summer's soft spot, bond yields dropped to similar levels seen today and the stock market fell 15%, but there was no recession. Instead, we got a second-half market rally as clarity improved and investor sentiment returned. In our opinion, the summer of 2010 is the more relevant comparison for what lies ahead for this market as opposed to the recessionary period of 2008-2009.

**While there is much to be worried about, I believe that the market's concern is overdone and it is pricing in a far greater likelihood for a return to recession than the data actually indicates.** Stock valuations are relatively cheap on both a trailing and forward basis versus their historical averages. The S&P 500 Index trailing price-to-earnings (P/E) ratio, a measure for how much the market values a dollar's worth of corporate earnings, is at 13 (the lowest since 1990) and the forward P/E ratio is 11 (same as the March 2009 low). Essentially, the market is as cheap or even cheaper now than it was during the depths of the 2008-2009 recession. While valuations could compress further, the spring is already tightly coiled. A solid earnings season suggests the market is too bearish with the price it is putting on earnings.

But, do not forget what turned last summer's market malaise into a double-digit second half rally for stocks: improving economic data, strong corporate earnings, emerging clarity from Europe, and above all, a market that was just too cheap to pass up the attention of investors. The bottom line is that the market has a blind eye to good news given the bearish-colored glasses it has been wearing as of late. **It is my opinion that volatility will remain very elevated, but the market's emotional sell off will soon transition to a rational assessment of moderately improving economic fundamentals and attractive valuations.**

The economic and market recovery is now well into its second year from the March 2009 lows and as any parent can vividly recall, this market "toddler" is just going through an old-fashioned "terrible twos" temper tantrum. But, market slides are where great opportunities are often born and this should prove to be no different. I believe that maintaining a cautious stance is prudent, but systematic additions to risk at these levels could prove to be a wise investment as the year unfolds. As always, if you have questions, I encourage you to contact me.

Sincerely,



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