



## Market Memo: "Fear Itself"

As of 08-12-2011

As we assess the market actions this week, it strikes us that President Roosevelt's famous phrase remains very much in play. Ironically, this week's sell off actually accelerated when the current successor to FDR's mantle, President Obama, stepped in on Monday to calm markets, but instead seemed to frighten them further.

The stock market is always part left brain, part right brain, and we don't want to discount the importance of psychology and emotion in setting stock market levels. However, lest we be carried off in a frenzy of fear, we thought it might be helpful to work through as coolly as possible the various fears on offer by this week's market observers as the cause of the current swoon. We find most of them not all that fearful.

### "The recession is coming! The recession is coming!"

Clearly, today's market minutemen – high frequency traders, ETF providers and assorted market speculators – are screaming loud and clear that a second recession is nearly upon us. We laid out our view on this topic last week in our piece, "There's not going to be a double dip" so we simply refer readers to that piece. We do think it's interesting to note that last Friday's non-farm payroll surprise was positive support for our "slow but steady" growth forecast, as was yesterday's surprise drop in jobless claims below 400,000 and today's solid retail report climbing 0.5%, just under 0.6% consensus forecast. None of these indicators suggest the economy is in the midst of a sharp deceleration to negative growth. Of course, it's possible we could talk ourselves into a double dip if the stock market doesn't settle down and enough decision-makers go from hitting the "pause" button to pressing the "reverse" button, but absent this, the fundamentals alone don't seem to be presaging another recession.

### "Frogs in the swamp"

Another fear that arose this week was that the government of France would join the Greeks in the fiscal swamp, which presumably will lead to a sovereign default. We are all for "trust but verify" and are certainly no fans of the French welfare state. This said, it stretches credulity for us that one of the world's wealthiest countries, which possesses a stockpile of assets dating back 700 years, is on the verge of sovereign default. Simply put, France is not Lehman Brothers II. In fact, France is no where near Lehman Brothers II. Lehman Brothers was levered 35 to 1 debt to equity; France doesn't publish the asset side of its balance sheet, but is probably in the range of 1 to 1 at least. On a debt to income basis, Lehman Brothers was running 165 to 1 in the months before its collapse; France is running currently at 0.9 times. And Lehman Brothers was funding itself largely overnight, so that its survival was entirely in the hands of the short-term capital markets; France's average debt maturity is 7.5 years, with less than 23% of its national debt rolling over in the next 12 months. And finally, and most importantly, Lehman Brothers, like any corporation, had a revenue stream dependent on its customers' willingness to do business with it; France's revenue stream is entirely a function of its taxing authority, which it controls. France, like most of the western G-7 governments, has a long-term mismatch between what it is spending and what it is collecting in tax revenues, but this is a problem which can and most probably will be addressed with long term measures. An imminent crisis is simply not in the cards.

### "If not the government then the banks!"

Another fear raised this week is that the pressure on the European sovereigns will ultimately take down the European banking system. The somewhat circular logic here is that the coming sovereign default would impair the banks' balance sheets by forcing a haircut on the very "high quality" assets to which the banks flew following the Lehman crisis, thereby bringing down the banks and with them, the European economy. The sovereigns wouldn't be able to bail out the banks since they themselves would also be declaring bankruptcy in an effort to lessen their future debt burdens. Under this unlikely scenario, the following would occur: the French government would be cut off immediately from the capital markets, forcing immediate cutbacks in government outlays to government workers and pensioners previously funded partly by debt financing; the French banks would go bust, evaporating in one blow the lifetime savings of the country's citizens; and shortly thereafter, social chaos would ensue. Note that under this draconian option, the French government would literally have to start the process by pulling the default trigger. The alternative scenario is the course the French and the rest of Europe have already embarked on: the slow and painful road of budget cutbacks designed to make them less dependent on external financing, gradually pay down the debt and keeping their banks solvent by continuing to pay the interest and principal on the national debt held by the national banks. In the meantime, under this more likely scenario, the French would presumably work with the Germans and other European governments to move towards some form of Euro-wide debt financing backed by the collective economy of Europe, not its weakest links. As we've said before, we are not expecting the sausage-making process to be pretty, but we are quite certain that sausage will get made.

Another way to think about this fear of the European banks is to review briefly the financial condition of one of France's national champion banks, BNP Paribas. BNP is one of Europe's highest quality banks, headquartered in France. Its stock is

down over 30% since July 1. BNP has a Core Tier 1 capital ratio of greater than 9% against a new regulatory minimum of 7% and it earned an annualized return on equity of 13.8% in the first half of 2011, adding further to its now 57.5 billion Euro capital base. Against this substantial capital cushion, BNP's total credit exposure to southern Europe is roughly 30.6 billion Euros, including Italy. So even if as much as half of its entire southern European sovereign debt were written off as worthless (a nearly impossible outcome), it's remaining capital base would still be north of 40 billion Euro.

## "There goes the safety net"

Another big fear out there, which might be fair enough, is that the fiscal mess in Europe and US, underscored by last Friday's S&P long term U.S. debt downgrade, means policy makers no longer have the financial flexibility to provide additional fiscal stimulus to a slow growing global economy. Under this logic, risk assets are worth less because there is no downside protection from the government. We concede that the government, thankfully, is pretty much out of the game in terms of fiscal stimulus both here and in Europe. But "P.S.": corporate CEO's, who have been forced to endure three years of being paraded down Main Street with signs around their necks reading "Dirty Capitalist Pig" have already figured this out. That's one reason that their balance sheets are as pristine as they have been in decades and that their working capital accounts are awash in cash. In a future piece, we will update our comparison of the composite balance sheet and financial condition of the S&P 500 to the U.S. government. Let me summarize it here – it's better.

## "Buy fear, sell greed"

As we have pointed out previously over the last two years, secular bull markets are not born in perfect conditions. In fact, the greatest ones in history arose out of the very messy and uncertain economic and stock market environments of the 1930s and later the 1970s. We are in such an environment today. Savvy investors should respect the fear in the market but also balance it with a careful review of the underlying fundamentals. With the market trading nearly 10 times earnings, we think most investors' worse fears are already priced in. We also think that we are a long way from where that other famous and dangerous investor emotion – greed—signals that it's time to sell. We continue to recommend investors add to equity positions in this fear-filled environment with equity overweight targets of 70% of their max range. Given the impossibility of timing a precise bottom to the current volatility, we suggest instead averaging into the markets through the rest of the summer as the cycle of fear plays out.



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