

Market View

PERSPECTIVES ON WALL STREET FROM 90 HUDSON

Despite the gathering strength of the U.S. economy, volatility has returned to the market. While nerves may have been jangled by the Dow's still-mysterious 1,000-point intraday crash and rebound on May 6, the drop in the market that followed over the next few weeks stemmed from broader concerns.

The most immediate concern focused on Greece and the fate of the eurozone. News of a rescue plan helped to calm markets, but investors remained nervous about the monetary union's ultimate fate. The European crisis also has raised fears of a double-dip recession in the United States. Fears have been further stoked by commodity prices, especially oil, which has come off recent highs. Meanwhile, Congress' attempt at financial reform has caused some anxiety as well about whether the legislation will stifle risk-taking and put the economy on a lower trajectory.

Investors' expectations also played a role in the recent market downturn. Buoyed by robust gains in the economy in recent months, many believed future growth would continue on the same plane, and invested accordingly. But while the economy continues to rebound, the pace of recovery has moderated, causing many to scramble to more defensive positions.

Addressing the euro crisis, its impact on the U.S. economy, and the outlook for the markets are Lord Abbett Partners Milton Ezrati, Senior Economist and Market Strategist; Zane Brown, Fixed Income Strategist; and Rick Ruvkun, Director of Equity Research.

Q: THE SOVEREIGN DEBT CRISIS IN EUROPE HAS ROILED THE STOCK AND BOND MARKETS RECENTLY. WILL IT ALSO HAVE AN IMPACT ON THE U.S. ECONOMY?

Zane Brown: To address the crisis in Europe, the European Union and the International Monetary Fund have provided liquidity. In exchange for the liquidity, Spain, Portugal, and Greece are implementing austerity programs. Even Germany has made budget cutbacks. But unlike during our subprime



crisis, Europe has not provided a fiscal stimulus. So, if it's a question of Europe slowing down and causing global growth to slow, indeed that is likely to happen.

Is that enough to push the United States into a double-dip recession? I think the argument is that it's not slower growth that will do it but the sovereign debt crisis. But I don't think that we'll

have a crisis that will be of enough magnitude to push us into a double dip. That is, I don't think it would be substantial enough to counteract the positive developments happening here.

We now have some job creation, which we didn't have six months ago, and some banks are now more willing to lend money. According to the Federal Reserve's quarterly survey of bank-lending practices, some of the large banks are willing to ease their credit standards a little bit for their large customers. And I think both of those argue against a double-dip recession here.

Because of the flight to Treasuries, interest rates are also lower now, which ought to help. So, if Europe grows by less than 1%, which seems likely, I think we'll end up with less growth [in the United States] than we would have otherwise. But that doesn't mean we're going to have a double-dip recession in the United States.

Rick Ruvkun: I agree. If you look at what kind of an impact a slowdown in U.S. exports to Europe would likely have on our GDP [gross domestic product] growth, it's somewhere between one-half and 1%. So by itself it wouldn't send us into a recession.

I think the way investors should look at the situation is in terms of a range or distribution of outcomes. In the middle of this distribution are some outcomes that have a high probability of occurring. At the two ends, or tails, of this distribution are the low-probability events. So there is a broad range of outcomes that could happen, and one low-probability outcome, or "tail risk," is the spread of the credit crisis in Europe such that it threatens the existence of the euro.

What has changed is that the probability of this crisis is higher than it was a few weeks ago. It's not clear to us now what the chances are that Europe's Economic and Monetary Union [EMU], or eurozone, will disband. But it's possible to conceive of a situation where France is uncertain about whether to form a new union with Germany or with southern Europe. There are a lot of permutations and combinations that could result in a partial disintegration of the EMU.

Brown: It's now becoming obvious that the different countries have different views about how they want to live and the sacrifices they want to make. As Rick was suggesting, it implies a greater probability that the EMU will disband, and therein lies the possibility of a greater crisis. There's a greater possibility now that it will all come unwound, and few people thought that six months ago.

Ruvkun: In the best-case scenario, the rescue package for Greece "kicks the can down the road." In the worst-case scenario, the eurozone falls apart. We've seen a high level of dysfunction among the governments there as they've tried to get their acts together. Witness Germany's ban on short selling, which they did without notifying anybody. That has some people saying, "If they can't even agree on short selling or its disclosure, then the likelihood of coordinated action to prevent the EMU from falling apart is even lower than I thought." So, there's not a high probability that we'll have a eurozone crisis, but it's higher than it was.

Q: WHAT ABOUT THE IMPACT ON THE MARKETS?

Ruvkun: The S&P 500® Index¹ was at one point up 75% over the March 2009 low, so many people were expecting a correction. Stocks have come down since mid-April, but was this caused by the pullback in China's stock market, or by financial reform legislation, or by the crisis in Europe? The answer is, all of the above. Or it might have happened anyway because the market had run up so far and so fast.

The bulls are saying this is the pause that refreshes, but the bears are saying the credit crisis might be here again. It could be that markets will tread water for a while until we can be confident that the credit crisis has passed—at least on the equity side.

Brown: We've really seen the same thing on the fixed-income side because the equity-like portions of the market, such as high yield, have followed the stock market. And the higher-quality portions such as Treasuries have benefited from the flight to safety caused by the European crisis.

Ruvkun: Credit spreads over Treasuries have widened, but not nearly to the level of 2008. So that would indicate that the

market's expectations of this crisis getting worse are low. If the crisis were to worsen, credit markets would completely freeze up, as happened in 2008 during the subprime meltdown, and you would see spreads widen more dramatically. All we're saying is that the odds of a greater crisis have gone up slightly.

Milton Ezrati: This response is normal. When a major credit such as Greece has trouble, you expect spreads to widen and liquidity to get a little short and people to flood into very risk-averse investments. This is actually a normal market response, not the end of the world.

Brown: If you look at the equity market, fear of a credit crisis has really trumped fundamentals. LIBOR [London Interbank Offer Rate, the interest rate at which banks make short-term loans to each other] has gone up, but only from 25 basis points [bps] to 45. A year and a half ago, it went from 25 bps to 460. Fundamentals are not nearly as bad as they were then. So, the equity market's reaction to this widening seems to be an overreaction. Banks are backing off a little bit, but nothing like what we saw here in 2008.

Ezrati: Earlier in the year, we saw a string of extremely good economic statistics that the market then extrapolated. And then we got this worse-than-expected report on weekly unemployment claims and some other weakness in the economy, and then the consensus expectation for employment for May came down. So, people are now thinking this recovery may not be as secure and robust as they thought.

But in our previous roundtable, Rick talked about the second derivative—that is, the change in the rate of change—and that's what this was. It's not that we went into a second dip but that the pace of growth was a little less firm than investors had extrapolated. But in reality, there's little sign of downward movement in the economy.

Ruvkun: Another way to put that is that the stock market had already priced in the recovery, and then people started mentioning a possible double dip, which caused investors to think about playing defense, shortening their investment horizons, and reducing their risk. When markets are up sharply, investors typically move their time horizon further out, and when the markets correct, they focus on the short term and move their horizons in.

I think it's important to remember that this is not just a Greek or European problem. If you look at gross debt as a percentage of GDP, Greece may not even be the worst case. In their book [*This Time It's Different: Eight Centuries of Financial Folly*], economists Carmen Reinhart and Ken Rogoff have shown that, historically, when that ratio rises to 90%, it's associated with lower growth, higher inflation,

or both. And the United States could reach that point, if the debt remains unchecked.

It's also important to consider the level of private debt. If you look at the situation on that basis, there are some nations, including the United States, that are moving in that direction.

Q: FINANCIAL PUNDITS HAVE BEEN WARNING THAT THE FEDERAL RESERVE'S POLICIES AND THE FEDERAL GOVERNMENT'S LARGE FISCAL DEFICITS ARE LIKELY TO LEAD TO INFLATIONARY PRESSURES, YET MANY ARE NOW WORRIED ABOUT DEFLATION. WHICH ONE SHOULD BE OF MOST CONCERN?

Zane: The argument for deflation is that inflation has been low, and now with the dollar appreciating, with Europe's economy slowing, and with China's demand for commodities waning, deflation is now likely.

But the downward pressure on oil prices could be a result of China and others filling their coffers with the commodities they need for the short term. Witness what happened to oil prices in May 2010 and you may get that with other commodities as well. That's really the argument for deflation in the short term.

Inflation isn't likely this year or next. It's smart to keep it in mind for the long term, but in the short term, the argument is stronger for deflation, or at least slower growth.

Ruvkun: I agree; we're likely to see deflation before you see inflation. I think we could have deflation for a year or two. But I think that ultimately we should be wary of a tipping point where the "bond vigilantes" could start demanding higher Treasury yields.

I don't know if they're right or wrong, but several notable people believe that these governments really don't know how to solve these structural deficits. I heard economic historian Niall Ferguson speak on this recently, and he's not very sanguine. The "nasty fiscal arithmetic," as he calls it, becomes especially troubling when interest payments make up a larger and larger share of the budget. As Ferguson pointed out, in this country they are projected to reach 20% of the federal budget within a few years.

The problem is that many things have to go just right in order for us to avoid inflation in the long term. Strategas Research refers to this difficulty as "sticking the landing." They say that real GDP has to rebound strongly enough that the recovery is convincingly sustainable, but not so strong or V-shaped that it leads to Fed tightening. Nominal GDP must rebound, but not so strongly that interest rates rise. In addition, the dollar must decline further, but not enough to lose its status as a reserve currency. We can't have commodity prices go up too much, or

that will put us into a recession. And we can't raise taxes too much, or that will stifle growth. So it's like a gymnast doing a dismount and landing perfectly—a lot of things have to go right.

The alternative to this is that the United States comes up with a great innovation that stimulates the economic growth rate, which will boost tax revenues—then we'll be fine.

Ezrati: The dollar will receive support from the Chinese. They have to defend the yuan, even with the decision to allow some appreciation.

Brown: Getting back to the deflation question, the increased risk of deflation has to concern the Fed. What this suggests is that we're going to have low interest rates for a longer period of time, and that there is no real need for the Fed to increase interest rates anytime soon. This may aggravate the problem with inflation after that time period, but for the next six to 12 months, yields on 10-year Treasuries and investment-grade bonds are likely to be lower than would have been expected.

Q: NEWS REPORTS HAVE REPEATEDLY DRAWN COMPARISONS BETWEEN GREECE AND CALIFORNIA. IS CALIFORNIA, OR ANY OTHER STATE, LIKELY TO PRESENT THE SAME MAGNITUDE OF RISK PRESENTED BY THE SOVEREIGN DEBT CRISIS IN EUROPE?

Ezrati: I don't think California will be the next Greece. Let me just put this into perspective. The aggregate deficit among issuers in the municipal market is one-tenth of the federal deficit. We're talking about approximately \$100 billion, largely concentrated in California, Illinois, New York, and New Jersey.

There's a lot of debt, and there's tremendous natural demand for this debt. But the idea that munis are following the way of the sovereigns in terms of their budgets and their debt situation is wrong. We're just not dealing with the same magnitude of debt.

Brown: Also, most states are required to balance their budgets, and they don't do it by short-changing bondholders or declaring bankruptcy but by cutting back on services.

Ezrati: Unlike the sovereigns, municipal governments can't change the rules after the fact. When much of Latin America went bust in the 1980s, they changed the rules. They extended maturities—ignoring what the contracts said—and they forced debt-for-equity swaps on bondholders. If California were to default, and I'm not saying they will, the bondholders will know exactly where they stand in the hierarchy, and could determine from the accounting exactly how much they were going to get. That's not the case with sovereigns.

Brown: And the defaults we have seen over the past year in municipals have been almost exclusively unrated securities;

most were less than \$10 million in issuance. Collectively, they were minuscule in terms of the size of the muni market.

Ezrati: In aggregate, over the past 40 years, municipal bonds have a 10-year cumulative default rate of 0.1%. That's all munis, rated and unrated. Over this same period, sovereigns have a 10-year cumulative default rate of 6%. So, munis are much more transparent. You know exactly what you're getting.

Q: CONGRESS IS CONSIDERING MAJOR REFORMS OF THE FINANCIAL SYSTEM. WHAT ARE THE LIKELY EFFECTS?

Ruvkun: Some believe that if the reform makes the system safer, it's also going to reduce economic growth. The question is, how much? Rodgin Cohen, who is the senior chairman at the law firm of Sullivan & Cromwell, has done some analysis of the reform legislation. The gist of it is that although the legislation makes the financial system safer, it will also reduce economic growth, and the magnitude of the trade-off is critical.

If reform reduces GDP growth by 0.1–1%, but enables us to avoid another major financial meltdown, then it's worth it. But if it reduces growth by 1–2%, and it gives us only a 50% chance of avoiding another meltdown, then it's not. One effect of this legislation is that it could seriously damage credit creation.

Ezrati: That's right. Why would a bank want to accumulate assets—that is, make loans—if the system is going to punish it for getting too big?

I'm not sure the legislation will make the system any safer. I think we're paying a price for nothing. Credit will be more expensive and harder to come by. But it will be delivered by someone other than those big banks. It may come from overseas.

I think there is going to be a bifurcated market. There will be the big banks, which will be highly regulated like utilities, and there will be a part of the market that will more actively serve credit needs, perhaps made up of subsidiaries of U.S. banks based overseas.

Ruvkun: The “shadow banking” system—hedge funds and any other entity that extends credit but isn't a bank—could become much bigger.

Brown: The risk-taking will be done by other entities, not banks. And whether it is done by the securitization market or by hedge funds, that function will be done by entities other than the banks, especially big banks that are targeted in the proposed reform regulation.

Q: WHAT IS YOUR OUTLOOK FOR THE MARKETS OVER THE SHORT TERM?

Ezrati: In the equity market, there's real uncertainty here: there's the European credit crisis and the legislative agenda in the United States. So, equities may go through a rough patch here, but unless you think that inflation will get so bad that interest rates go skyrocketing, equities should fend reasonably well in a modest inflationary environment—underscoring “modest.”

Ruvkun: I would put it slightly differently. We have a broad range or distribution of outcomes for GDP. I mentioned earlier the low-probability tail risk of a deflation/credit crisis/double-dip scenario in the short term. The other low-probability tail risk is inflation. But between those two tails, the most likely outcome is an extended recovery, albeit more slowly than normal and with high unemployment. So further upside to the market is likely. You have a likely downside at the two tails because, if you have inflation, multiples will compress, and if you have deflation or a double-dip recession, then you have lower earnings.

Brown: The S&P 500 is now [as of May 24] at 13 times first-quarter earnings, and we have the tail risks of inflation and deflation and the euro crisis, which are higher than before. But if you look at the fundamentals in the United States, there is reason to believe that there is still upside to the stock market. A low interest-rate environment, combined with some economic growth and job creation, does suggest some upside in equities.

In the fixed-income markets, over the next three to 12 months, we expect to see spreads relative to Treasuries compress as investors find rates of zero to 25 bps in money market alternatives too painfully low to endure. They're not doing that today, but I would suggest that over the next three to six months they could move money back into high-yield securities, and we could see spreads compress again. As spreads compress, investors could end up with a great income stream and some price appreciation as well. So if investors are looking for an investment alternative over the next three to 12 months, high yield still makes an awful lot of sense.

Similarly, among shorter maturities, a floating-rate portfolio backed by loans may provide attractive income with the opportunity for portfolio yields to adjust higher when short rates begin to climb. Finally, a higher marginal tax bracket increases demand for municipals, while the Build America Bond program reduces supply, especially among longer maturities. Such dynamics provide great fundamentals for tax-exempt securities. The opposite, however, may be said about the Treasury market, where fear has temporarily produced a flight to quality. Yet even that may be insufficient to absorb future Treasury supply at prices close to current levels.

¹ The S&P 500[®] Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

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