

Roosevelt Investments Market Commentary

September 2011

Sovereign debt concerns in Europe have reached a fever pitch, with credit default swap pricing now predicting a near certainty of default for Greece and elevated risk for some other large issuers including Italy. European bank stocks have fallen significantly on fears of overexposure to Greece and other weak credits, as well as doubts regarding capital sufficiency. Overriding investor concerns relate to the possibility of a Eurozone recession impacting our fragile economy, and the chance of a major European bank failure resulting in a Lehman-like collapse with global impact.

Financial markets have responded to these issues in a number of ways, but the most obvious is the persistent and heightened volatility. After spending most of the year below 20, the CBOE Volatility Index (the VIX) has been above 30 for the past five weeks. There have only been a few periods over the past decade where volatility has persisted at this level for this long. As might be expected given the Eurozone banking system concerns, shares of banks and other financial services companies have dramatically underperformed a down stock market, with what many consider the weaker among the major U.S. banks off nearly 30% just over the past six weeks. Some of the larger Eurozone bank stocks have fallen 50-60% over the same period.

Second quarter U.S. GDP was reported in late August, growing at just 1%. This means the first two quarters of 2011 are the weakest since the statistical end of the recession in 2009. Ongoing concerns regarding the trajectory of the U.S. economy appear justified, since, as we noted last month, the economy appears to have downshifted into 'stall speed.' Despite this, while macroeconomic data deteriorated from May through July, there were areas of improvement during August. The Conference Board's index of leading economic indicators rose more than expected in July. Bank lending continues its uptrend from earlier this year and grew by the most in nearly 3 years. This is important because we need to see banks resuming their role as providers of credit and liquidity to the economy, particularly whenever the Fed steps back from its stimulus measures, and bank lending is an important, fundamental driver of an economic recovery.

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As we review the last six weeks or so of economic data, many of the negatives relate directly or indirectly to deteriorating sentiment. The very public lack of leadership by our elected officials in recent debt ceiling discussions combined with the S&P downgrade of U.S. debt and the ongoing weakness in our economy have manifested themselves in sharply declining consumer confidence. In fact, one Boston-area survey respondent to the Fed's Beige Book survey noted that "the country is talking itself into a recession." In our view, this may be one of the biggest internal issues facing our economy today: the self-reinforcing downward cycle of weak sentiment negatively impacting the stock market, which causes further weakness in sentiment, and so on. While consumer sentiment surveys have been very weak, actual spending patterns to date have not correlated closely with sentiment. Recent consumer spending was above forecast levels, August retail sales were stronger than expected and retailers earnings reports were, in general, surprisingly good. Auto sales were strong in August, dealerships also reported good Labor Day weekend activity.

Confidence levels of business leaders have not declined nearly as much as those of consumers. While hiring activity remains modest, businesses continue to spend on capital equipment. July durable goods orders rose more than expected, and importantly the ISM non-manufacturing index, representative of roughly 90% of the U.S. economy, gained ground for the first time in four months and rose to 53, several points above the level that marks the boundary between economic expansion and contraction. July's reported trade gap was narrower than expected, driven by strong export activity, a positive for 3rd quarter GDP. Shipments of capital goods, autos and auto parts overseas were the strongest on record. Many regional Fed surveys, however, have been weak.

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In an assessment of the multitude of significant events of the past two months, we find ourselves attempting to solve an equation with an unusually large number of variables. Internationally, concerns include geopolitical events in the Mideast, the Eurozone sovereign debt crisis and related concerns about economic weakness from regional austerity measures, and fear of a possible 'hard landing' scenario in China associated with numerous tightening measures undertaken by that country's central bank. On the domestic front, a weaker than expected U.S. economic recovery and possible double dip, the S&P downgrade of U.S. debt, and the disappointing and highly politicized debt ceiling discussion between Congress and the White House have all contributed to uncertainty. Investors collectively appear to have reached the conclusion that this equation is too complex to solve, and in response have been selling stocks somewhat indiscriminately in an attempt to de-risk portfolios. Evidence of this can be seen in the very high correlations among stocks at present.

We await resolution of the headwinds in Europe and the U.S., and at least government officials are now asking the right questions and dialogue is moving in that direction. The Fed, we believe, understands the problems and will act in concert with the administration to enact further monetary and fiscal stimulus. Chairman Bernanke said in August that interest rates would be maintained at very low levels until mid-2013, and additional stimulative policy may be announced at the two-day FOMC meeting later this month. The Obama administration proposed a jobs program to be funded by tax increases and has asked Congress to enact the legislation without delay, although it is unclear how cooperative Congress will be. When all is said and done, our view is that the economy will retain its moderate, stall-speed growth rate but is unlikely to slip back into recession.

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