MARKET FLASH

PineBridge Investments

Post S&P US Sovereign Downgrade: Strategy & Market Perspectives

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Executive Summary

With the US economy showing signs of having stalled, deceleration of Asia's growth engine and financial contagion spreading throughout Europe, risk assets buckled last week. Markets have rejected the notion that the slowdown in the first half were related to one-time factors and are trading as if recession is here. This "confidence" recession is also being fueled by skepticism of policy makers' ability to respond adequately. However, underlying corporate fundamentals suggest that the US economy's trajectory has begun to trend upward. This, in conjunction with more effective policy making going forward, means that we are actually in an environment where the potential recovery trend remains fairly robust. As such, the S&P downgrade should have little impact on the US and global growth outlook.

Earlier this year, as we de-risked our asset allocation portfolios, we found ourselves asking "what can go wrong?" Now, given the market's much different risk/return payoff, we find ourselves asking, "what can go right?". Often, markets are frustratingly disconnected with economic developments over periods shorter than nine months. Yet, the landscape is now set for one of those rare moments when these two are one and the same. We believe the economy's direction, along with the ability of policy makers to demonstrate relevance, will determine the fate for risk assets for the remainder of 2011. We're increasingly bullish versus today's expectations on both accounts.

After the October 1987 crash, analyst meetings all sounded the same. Managements were drilled in patronizing tones about why they couldn't see the weakness in their own business. "It must be there, haven't you seen your stock?" In the end, business was fine for the remainder of 1987 and all the way through 1989. Markets quickly rebounded to new and much higher highs. Using price to see fundamentals proved to be risky business; not risk reducing. Then and now, investors viewed mixed news by focusing on and amplifying the negative outliers while completely ignoring the positives, for awhile.

So what can go right? China, after focusing exclusively on slowing its economy could change its tune and direct its command and control lending apparatus into stimulus mode. In 2009 this instantly turned around their economy which helped other economies to stabilize and to grow again.

European leaders may finally be chastened by last week and act sooner than October on their financing issues. The European's Central Bank's (ECB's) decision to start, what amounts to QEII is a step in the right direction and could have positive implications for asset markets more broadly. It was only 2008 when it acted with other governments in perfect unison.

In the US, furor over the downgrade may help the new Congressional super committee to appreciate the growing anti-incumbent mood should they fail to compromise like Americans. The new split rating (Moody's & Fitch still rate US debt as AAA) may prove a non-event as was the case for Japan and Canada. The gradual acceleration of the economy, which all believed in until last week's price action (and before the July employment report which strengthened the case for gradual improvement), may turn out to be more right than wrong.

In short, while a double dip cannot be ruled out, and would be very severe should it occur, a double dip is all that matters and remains very unlikely in our view. What has changed since last week is a much better risk/return payoff for asking the question "what can go right?"

Viewpoint: Listed Equities

Over the past few years we have had a handful of periods where market action dislocates from company fundamentals. This is one of those times. There is a clear dichotomy between strong corporate fundamentals, and macro, fear-driven, headline risk. Better than expected corporate earnings, stronger than expected job growth, and other positive economic data points have been overshadowed by the underwhelming debt ceiling solution, European stress, and a debt downgrade by S&P. The S&P 500 has been down well over 10% the last two weeks and market volatility is up over 200%.

We disagree with the notion that fundamentals no longer work. While we may be in a period of market dis-location, we believe it to be transitory. Results from second quarter earnings season in the US continue to confirm strong corporate fundamentals, with approximately 70% of S&P companies beating expectations both on earnings and revenues. The recent S&P downgrade will, and has, exacerbated the crisis of confidence. However, strong corporate fundamentals (balance sheets, earnings, sales, etc.) will bear out. Furthermore, the employment backdrop continues to strengthen and should continue to do so within identifiable segments within the economy.

Viewpoint: Fixed Income

The downgrade has been felt across all markets. Despite the fact that it was widely telegraphed by the rating agency, markets have reacted by selling. Following the downgrade, weakness has spread, rather abruptly in some cases, to encompass all sectors as sellers have emerged and buyers remain wary. Moreover, Financials have continued to underperform as fears of related downgrades in that sector have impacted the market.

The market reaction appears more psychological in its impact than something that will have meaningful near-term implications. Market concerns are focused more on economic growth and European debt concerns. US Treasuries continue to exhibit the qualities of a "safe haven" asset class, given their strong performance of late. Longer term concerns about the creditworthiness of the US are reflected in the steepness of the yield curve, notably the 10-year to 30-year curve, which has steepened only three basis points since the downgrade, but stands at a historically steep +132 basis points.

Investors are wary of market conditions and not willing to put money to work until more clarity is seen on the US and global growth picture and the European debt problem. In review, investors have been hit with a multitude of negative factors and events over the last several weeks. However, rather than viewing this as a return to a 2008 type scenario, we see it more as a return to a May 2010 scenario. In May of last year, the market was hit with a number of negative events and a significant correction took place.

Nevertheless, the market now is in a markedly different position with factors including a more stable technical environment. At present, although monetary options are more limited in the US, as an outright QEIII may be politically difficult, further actions from the ECB to address issues there are likely. In addition, the market seems to be asking for a more comprehensive approach, expanding the ESFS (European System of Financial Supervisors) and perhaps issuing debt from this entity.

As these issues are addressed and the impact of the rating downgrade subsides, we would expect market conditions to calm. In sum, given our view that we are not headed for a recession and that the near-term repercussions from the downgrade should be limited, we view this market as attractive. ■