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Investment Commentary

Commonwealth Bank & Trust Company

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The concerns over Europe that sent risk assets reeling in the third quarter were replaced by optimism that a resolution would be reached, leading stocks around the globe to rally sharply in October. Large-cap domestic stocks, as represented by the Vanguard 500 Index, returned nearly 11% in October, the mid- and small-cap benchmarks also generated double-digit gains. Year-to-date (thru October), large-cap gains have moved back into the black, while mid- and small-cap stocks remain in negative territory, with 1% and 4.5% losses, respectively. Turning abroad, the Vanguard Total International Stock Index was up over 10% for the month and the Vanguard Emerging Market Stock Index rose 13.5%. Year-to-date, both indexes remain well in the red (-9.6% and -13%, respectively).

As is often the case in periods with strong equity gains, lower-quality credit outperformed higher quality. In October, the Vanguard Total Bond Market Index gained 0.2%, while high-yield bonds gained close to 6%. Year to date, however, high quality is outperforming. Overseas, the story is the same, with high quality lagging low quality during the month, but outperforming for the year-to-date period. In October, Citigroup World Government Bond Index gained 0.5% and the JPMorgan GBI-EM Global Diversified Index, gained 5.6%. Year-to-date, high quality is up over 7%, while emerging-market debt is up 3.2%.

Research Team Q&A

We regularly use a question-and-answer format to address questions from readers about our investment views and current strategy. This format permits us to address a range of different topics and allows readers to focus on areas that are of interest to them. This Q&A piece addresses several questions that we have recently received.

Q: In previous commentaries you have written that macro forces, since 2008, have become more influential on your investment strategy. Can you talk more specifically about how macro-level considerations influence your investment process?

Our investment process does not rely on short-term forecasts of the macro economy, GDP, interest rates, or other economic variables. It is our belief, and history has shown, that very few people (including professional economists) can make consistently accurate macro forecasts over time, and more importantly predict how financial markets will react over short periods of time. That being said, we follow economic and market cycles closely because volatility in these cycles can lead to tactical asset allocation opportunities. Tactical asset allocation simply means that asset classes tend to deviate from their intrinsic value as prices are influenced by economic growth, sentiment, interest rates and other factors. For example, stocks and other risk assets become cheap during recessions and bear markets as investors become too pessimistic about future earnings growth. These deviations from intrinsic value (or over-reactions) create opportunities for investors, our value-driven approach to tactical asset allocation gives us confidence that if and when asset classes become significantly overvalued we will reduce our exposure to those asset classes, and vice-versa when they become significantly undervalued we will increase our exposure.

To improve our asset class analysis we consider several macro scenarios, where each scenario encompasses different broad assumptions about the economic environment that will play out over the next five years, such as whether it will be a deflationary or inflationary, normal growth, or subpar growth environment. These broad macro scenarios help us to arrive at reasonable expected-returns for different asset classes, and possible ranges for those returns. As a result of the excesses prior to and the aftermath of the 2008 financial crisis, we believe we now need to consider a wider range of potential macro scenarios and outcomes. Unfortunately, the range has widened to the downside rather than the upside in our view. This consideration has put a greater emphasis on risk management in portfolios.

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Q: Can you explain the European sovereign debt crisis and what the endgame could be?

In short, the resolution of both short- and long-term problems are in the hands of political leaders and central bankers who are operating with divergent interests, and so solutions have been slow and piecemeal at that.

The problems we are seeing in Europe are a symptom of the excessive debt we see in much of the developed world and the need for them to delever (reduce debt). The deleveraging process is never easy, but it is further complicated in the case of Europe because of a few factors:

- The most acute need for deleveraging is in peripheral Europe (Portugal, Ireland, Italy, Greece and Spain aka the "PIIGS). Because they are in a monetary union and united by one currency, the Euro, they cannot individually depreciate their currencies. Limiting their ability to grow and ease the pain of deleveraging.
- The problem has festered for well over a year, and, as a result, has become a bigger problem and is enveloping larger countries, such as Italy and Spain. The problem has worsened in large part due to conflicting political motivations. For example, Germany and the European Central Bank do not want to reduce Greece's debt and create a moral hazard that encourages more irresponsible borrowing and spending by other EU members. So, instead of recognizing that Greece is insolvent and cannot pay back its debt, they have been forcing Greece, Ireland, Portugal, Italy and Spain to undertake fiscal austerity, worsening their economic slowdown and balance sheets.
- European banks have huge exposure to the sovereign debt of struggling European countries, so there is a risk of a serious banking crisis that impacts broader Europe. Given the financial linkages to Europe across the globe, there is concern the problem could precipitate another global financial crisis and a recession.

The endgame is difficult to predict, given the unstable political situation in the EU countries. In late October, Eurozone leaders took the first step of recognizing that Greece cannot pay back its debt and that banks need to be recapitalized, although the mechanics of achieving both objectives in a sustainable fashion are not yet clear. It is also unclear whether the broad steps agreed upon will solve the competitiveness problem that many peripheral countries face. Moreover, a likely economic slowdown in Europe, could reignite Europe's debt crisis. Meanwhile, stronger Northern European countries want countries like Greece to pay for their fiscal imprudence. Inflicting austerity measures, however, may become counterproductive if it leads to slower growth and causes local populations to protest and to accept the financial pain of austerity. The lack of a cohesive political agenda will keep financial markets volatile as participants fail to see a clear path to the end of the crisis.

Q: Some commentators compare the current environment to 2008. Could it be that bad again?

Yes, it could happen. Much of the globe is deleveraging and as such markets will remain susceptible to disorderly events and periods of financial crisis (as happened in 2008 and, even worse, in the 1930s). If Europe's sovereign debt crisis spreads even more to Italy and Spain then it may become too big for an orderly solution; or if Greece and other peripheral countries were to exit or be forced to leave, that may be disorderly and lead to a 2008-like environment. We are already seeing strains in the European banking system that could lead to further problems.

Some readers may wonder why we do not suggest selling all risky assets. The answer is we don't think a credit crisis comparable to 2008 is a high probability. Therefore, the opportunity cost of selling all risky assets from a portfolio becomes very high if the worst case is avoided.

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The next question might be: Why do we think this worse-case scenario is not a high probability? First, we are not starting from an economic peak, so arguably fewer excesses need to be squeezed out if we were to go into another recession. Second, policy makers have been proactive and hopefully will act in time to safeguard the system. Third, corporations have been increasing cash balances and paying off debt, making them financially healthier and better prepared for a potential crisis. Finally, we may not suffer an acute liquidity crisis similar to 2008 because swap lines among key central banks have been established to provide greater liquidity.

However, if another 2008 does play out, it is likely to happen quickly. Therefore it is important that clients are in the right investment strategies that appropriately reflect their risk tolerance. In general, we have been emphasizing risk management and alternative strategies in portfolios to counter market volatility, however, if you have any questions on your investment strategy and risk tolerance please give us a call to discuss.

Q: Given the uncertainty in markets can you highlight some of the investment themes and strategies you are using in portfolios?

Quality bias – We continue to believe that the highest quality stocks are attractively valued relative to the general market. We are emphasizing stocks that are well-managed, have strong competitive advantages, lower levels of debt and attractive valuations. Many of these companies are priced to deliver good risk-adjusted returns over the next five years, even if markets remain volatile.

Exposure to emerging markets (direct and indirect) – The financial condition of many emerging countries are in better shape (less debt) than those of the developed world and their economies are growing faster. We want to participate in that growth from direct investments (funds and ETFs) and from domestic stocks (indirect) that sell into those markets, especially since valuations are reasonable.

Cautious on bonds – From our perspective, the valuation on most bonds look expensive and are priced to deliver meager returns over several years. That being said, there is no law that says they cannot rally further and become even more expensive, especially if macro concerns continue. We are utilizing alternative strategies to supplement fixed income strategies and hedge against negative real interest rates.

Selectively utilize absolute return strategies – These strategies are designed to have a relatively low correlation to traditional investments (stocks and bonds) and can reduce the overall risk of portfolios. These investments should provide solid risk-adjusted returns and help to diversify your investments.

Please contact us if you have any questions regarding this commentary or investments in general. Thanks for your confidence.

—CB&T Investment Team (11/11)