



## Strong Market Finish for a Lackluster Quarter

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Stock prices declined for much of the second quarter, as the economic recovery lost momentum. Inflation increased, and a possible default by Greece caused widespread concern. But losses on U.S. stock funds were in large part erased by a big rally in the final week of June.

U.S. stock funds, excluding sector funds, returned -0.4% on average in the second quarter, according to Lipper, a unit of Thomson Reuters. Diversified international stock funds returned 1.2% on average. Intermediate-term investment-grade bond funds returned an average of 1.8% in the quarter, while the average general municipal bond fund returned an impressive 4%.

### Economic Headwinds

Over the past several months, the U.S. economy has, indeed, gotten worse. Earlier this year, the expansion was progressing, but then a number of obstacles appeared in the road. Supply chain disruptions were caused by the disaster in Japan. Military intervention in Libya contributed to rising oil prices, which in turn undermined consumer confidence.



In addition, there is the threat of a Greek (and maybe some other European nations) debt default. Businesses have been reluctant to hire for fear that the signs of improvement are transitory; thus, the unemployment rate remains stubbornly high.

Falling stock prices are both a cause and effect: if investors don't feel as wealthy, they tend to curb their spending, which has a depressive effect on economic growth. The debate over the U.S. debt-ceiling limit has only added to the uncertainty.

With so many hurdles to clear, it isn't hard to understand why the economic expansion slowed considerably in recent months. Many economists believe the economy's slowdown is temporary, and that momentum will pick up later this year. Only time will tell. But it's clear that there are many challenges facing the U.S. economy at the moment.

### Cautiously Optimistic

Despite the short-term factors that are contributing to current pessimism and doubt, there are important longer-term trends that bode well for the economy and the financial markets, trends that support a cautiously optimistic outlook.

A complete recovery from the financial crisis and the residential housing market collapse will probably take a long time. Gradual and uneven growth should be expected, with some sectors of the economy needing much more time than others to return to their pre-recession levels. In the meantime, consumers have made considerable progress throughout the recovery in reducing or

eliminating debt. Consequently, consumers' balance sheets are much healthier now than they have been in a long time, which— if a modicum of confidence returns—makes it more likely that consumer spending will again become an important driver of growth over the next year and beyond.

Corporate balance sheets are also strong, and growing corporate earnings combined with the low cost of capital supports the view that as confidence returns, the purse strings will loosen and a lot of pent-up corporate spending will occur, contributing significantly to economic growth.

### **Bonds: Be Calm, Be Thoughtful, Be Conservative**

Bond returns accelerated during the second quarter, reversing losses from the January-March time period. Investors voted for stability with their wallets over the largely unfulfilled promise of economic growth.

The Barclays U.S. Aggregate Bond Index returned 2.29%, up from 0.5% in the first quarter of 2011. The Municipal Index returned a robust 3.89%, as overblown fears of a credit meltdown abated, and issuance dropped precipitously, squeezing supply.

Looking within these numbers, U.S. Treasuries outperformed the Aggregate and junk bonds lagged. Among municipals, longer maturities generated the most total return, as yield-starved investors bought longer-term issues to capture higher coupon interest, thus extending the duration and maturity of their portfolios in the bargain.

Global investors perceive U.S. Treasuries as a benchmark and a haven of safety. As Greece teetered on the edge of default in June, the 10-year Treasury yield dropped 0.18%. When the crisis was resolved favorably, the flight to quality abated, and the yield rose 0.14% in just four days.

“Default” is the major concern of bond buyers today, overshadowing fears that interest rates will rise with economic recovery. Greece avoided default on its sovereign debt at the end of June, but the cost of austerity—civil unrest—was high. The United States is facing a showdown on the debt ceiling, which promises to be an ugly game of brinkmanship. It's useful to ponder what might happen if the U.S. allows a default to happen—even temporarily. Here are some possible scenarios:



- Interest rates would rise, and bond prices would fall. Currently the U.S. government pays slightly less to borrow than most major industrial nations, just over 3% on a 10-year note. Brazil, which is not an immediate default candidate but has high inflation, pays over 12%.
- The value of the dollar would decline, leading oil prices (quoted in dollars) to rise, rekindling inflation.
- Relationships between the U.S. and China, whose central bank owns trillions of dollars of U.S. Treasuries, would be jeopardized, with unknown consequences.
- U.S.-based corporations, whose borrowing costs are based on Treasury yields plus a risk premium, would have to pay ruinous debt service on new borrowings, stunting domestic economic growth.
- Adjustable mortgage rates would rise, further weakening the housing recovery.

- Great wealth would be lost, jeopardizing millions of retirement plans and endowment funds. Remember, bond yields and prices move in opposite directions.

Our thinking is that the impasse in Washington will be broken before August 2nd, because neither party will risk being blamed for allowing a default to occur; that could be more damaging than stepping back from entrenched positions on taxes and entitlements.

We caution investors not to make extravagant bets on the next month's action. Globally, the markets have not exhibited the volatility or capitulation that indicates abject fear.

The risk of making a rash and expensive move that turns out "wrong" outweighs the risk of staying the course with intermediate term, investment grade bonds and funds, and riding out any short-term disruption in the market.

### **Where Will the Markets Go From Here?**

Investment professionals are often asked to assess the future—for economic growth, inflation, interest rates, the stock market, and so on. But such predictions are always extremely difficult to do with any semblance of accuracy—a fact of life that is often lost on the investing public.

First Affirmative does not offer short-term prognostications on the markets. We don't have a crystal ball. We appreciate and respect the old adage that we must "treat the future with the humility it deserves." Instead, we offer some perspective as to the risks and opportunities, and caution readers not to be unduly influenced by the financial media.

An uneven, "two-steps-forward, one-step-back" recovery continues to be a probable short-to intermediate-term future scenario for many aspects of the economy as well as for the economy as a whole. There is a large oversupply of housing that will not be absorbed quickly, and there is a movement toward fiscal austerity across much of the developed world. Progress will take time. It would be naïve to expect the road to economic recovery to be smooth.

### **Patience, Diversification**

The expectations described above provide a strong argument for broad diversification and balanced investing in the years ahead. The good news about the many economic concerns we face is that they are already well known. They are already priced into the market. Only surprises, positive and negative, will cause markets to move up and down. Given the crosscurrent of positive and negative trends, we believe that "cautious optimism" is justified, with equal emphasis on both words.

### **Keeping Bad News in Perspective**

Volatility is unlikely to subside very much as long as hordes of investors trade with a "risk-on, risk-off" bipolar approach, whereby the release of each new economic datum is regarded as a verdict on the entire global economy. Volatility is what makes investing so nerve-wracking. One way of coping with volatility is to examine a period in the past when conditions were similar in some ways to conditions today, and to study what ultimately happened.

Past episodes of volatility have taught us repeatedly not to expect sustained stock price declines in the wake of negative news. This is very counterintuitive, and so we repeat it: Past episodes of volatility have taught us repeatedly not to expect sustained stock price declines in the wake of

negative news. For a recent episode, we need not look farther back than the litany of bad news from the spring of last year.

The Greek debt crisis reached the crisis stage for the first time, as rioters in the streets of Athens clashed with police. Investors were left dazed and confused by the May 6th “flash crash,” when the Dow Jones Industrials Average plunged about 900 points, only to recover those losses within a matter of minutes. BP was desperately trying to control an oil gusher in the Gulf of Mexico. Air travel in Europe was suspended for days as volcanic ash spewed into the atmosphere. All the while, U.S. economic indicators pointed to a slowdown. After a volatile summer, global stocks advanced sharply, rising 30% from September 2010 through April 2011. Not many experts predicted that!

When negative news accumulates, markets tend to react in sympathy. But as events evolve, market performance often changes quickly. When negative events are transitory while the medium- and long-term fundamentals for a cautiously optimistic outlook remain in place, investors should be positioned for positive surprises. Always be mindful that markets are forward-looking; they reflect the consensus expectations for the economy going forward. Short-term volatility is merely uncomfortable noise, a distraction. Investors must simply learn to cope with it as the price one must be willing to pay for long-term investment success.

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