

The Week

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Worth noting

- The decline in the stock market during the past month shows that investors' appetite for risk has clearly decreased.
- The economic news is better than it was a year ago, but investors are focusing more on government efforts, both here and in Europe, to deal with lingering debt problems.
- Investors are increasingly worried that policymakers are making mistakes, threatening the global economic recovery.
- Policymakers need to show greater resolve to deal with these problems and provide a clearer message to reduce investors' concerns.

Are policymakers making mistakes?

One lesson that investors learn over and over again is that unexpected events can happen at any time. Investors have known about Greek debt problems for six months or more. What investors did not know is what European policymakers would do about these problems. During the past couple of months, policymakers' efforts to deal with Greece's debt problems have raised investors' concerns, not diminished them, and investors are now casting votes of no confidence against policymakers. Moreover, U.S. policymakers continue to follow agendas that put the United States at risk for similar problems.

In our 2010 economic and market outlook, we concluded with the caveat that the greatest risks to the markets were unexpected events. When we wrote that report, we were concerned about policy risk as well as the potential for terrorism or a war in the Middle East. As it turns out, policy risk has been the biggest threat. The Fed did not raise interest rates too soon as we thought could be possible. But Congress continues to spend more than it receives in taxes. This remains a concern. We concluded by saying that the greatest risks are often unforeseen events that are not even on the radar screen. Mistakes by European policymakers fit into that category. We concluded by saying that the impact of unexpected events will depend on the level of stock prices, valuations, sentiment levels, interest-rate levels, monetary fiscal policy, etc., at the time they become problems. In other words, the impact depends on whether the market is elevated or depressed.

Unfortunately, the new concerns that European policymakers are making mistakes developed after the U.S. stock market, as measured by the S&P 500, rallied more than 80% from its March 2009 low. Consequently, these new concerns have caused stock prices to drop swiftly from those elevated levels. As stated in previous editions of this report, the S&P 500 hit our equity strategy team's year-end target of 1175-1200 in early April. As a result, we anticipated that market returns for the rest of the year would be more modest, and the markets could be more volatile. The increase in market volatility during the past month is a dramatic change from the orderly advances in the U.S. equity markets in March and early April. So what has changed?

Greece's sovereign debt problems have been known to investors for a long time, but investors are becoming increasingly disappointed in how policymakers are handling these problems. European policymakers initially proposed a short-term liquidity package to help Greece pay its debts for the next year. It did not take long for investors to realize that this only delayed an even bigger debt problem until next year. In other words, policymakers were putting a small band-aid on a big wound. Investors were disappointed and both the euro and European stock markets declined, pulling U.S. equities down also. After a sharp drop in global equities in early May, European policymakers proposed a larger, more comprehensive aid package, potentially providing funds to other countries to prevent the Greek problems from spreading beyond the euro-zone's smallest economy. The announcement of this new package helped stock markets bounce sharply, but there was little follow-through buying. Consequently, the equity markets dropped again within a few days, especially after the decline in the euro accelerated. Finally, the biggest policy mistake may have been Germany's unilateral decision to ban naked short selling of some financial instruments to reduce speculative selling. This was interpreted as a desperate measure by one country rather than the coordinated action that investors wanted to see.

The U.S. equity market declined along with the European markets because many investors are worried that the United States could have its own sovereign debt problems in the future. According to the International Monetary Fund (IMF), the net federal debt of the United States as a percent of gross domestic product is expected to be 66.2% in 2010. That is only slightly less than the net debt of the euro area, which is expected to be 73.9% this year. The United States may not be at the front of the line of countries with debt problems, but it is not at the back of the line either. Therefore, U.S. legislators need to reduce the U.S. deficit and U.S. borrowing or the United States could be near the front of the line within a few years.

So what do investors want to see? What should policymakers do? At this point, European policymakers need to work together rather than independently. Moreover, European policymakers need to show greater resolve to deal with these problems and clearly explain how it will deal with long-term issues such as the lack of coordinated budget restraint by individual countries in the euro-zone.

As indicated in last week's report, if the U.S. equity market, as represented by the S&P 500, convincingly breaks below the February low of 1044.50, the current correction could last through the summer and into the fall. Many investors remember the big drop in equities during 2008 and worry about a repeat of that slide. The big difference is the global economy was in recession in 2008; now it is in recovery. Therefore, a repeat of 2008 is unlikely. Nevertheless, global equity markets could suffer more if policymakers do not act soon to counter investor concerns.

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