



Riding the Financial Roller Coaster

Pepto-Bismol may become the new best-selling remedy for those riding the roller coaster, better known as “The Stock Market”. The recent huge swings and the market’s increased volatility have definitely had all of us fastening our seatbelts a little tighter. Or, maybe it has some of you looking to exit the vehicle! So, just in case this thrill ride continues, let’s pause and take a closer look at the situation after removing fear and emotion from the equation.

Despite the turmoil in Washington and the current intense volatility of the stock market, things are not as bad as they may feel. Though a comparison can be made, this is not the second coming of the “Great Recession.”

The TED Spread

The underlying causes of the downturn in 2008 — the housing bubble and credit crisis — have stabilized and are slowly recovering. In addition, U.S. banks are in much better shape today and a classic measurement of stress in the financial markets, the TED spread, has normalized since 2008. You may be asking, “The ‘WHAT spread’?” The TED spread is the difference between the T-bill rate (risk-free rate of return) and LIBOR (the rate banks charge to lend to each other). Essentially, the TED spread is an indicator of perceived credit risk in the general economy. When the spread rises, that’s a sign that lenders believe the risk of default on interbank loans is increasing. Currently, the T-bill rate is .02% and LIBOR is .20%, meaning the TED spread is .18%. TED spreads are normally within a range of .10% to .50%. At the height of the 2008 crisis the TED spread was more than 4.50%! Clearly banks didn’t trust each other and the crisis was in full swing. The market’s current state, on the other hand, has been shaken in large part due to the downgrade of the U.S. AAA credit rating.

The result is that global equity markets are down across the board and investors are fearing the dreaded “double dip recession.” With GDP up less than 1% annualized during the first two quarters of 2011, negative consumer spending and unemployment still above 9%, there’s no denying that Washington needs to address several issues. However, is this situation on par with the crisis of 2008? We think not. The credit downgrade has produced anxiety, which exponentially increases the volatility of the stock market as it reflects uncertainty around these issues.

Credit Rating Downgrade

However, the downgrade of the U.S. credit rating from AAA to AA+ may actually end up being a bigger blow to our nation’s psyche than to the equity and bond markets. If history is any indication of the future, downgrades of other sovereign debt, seen in countries such as Canada, Australia and Japan, have not necessarily led to poor equity and bond market performance or increased borrowing costs. Remember, the United States is still the world’s largest economy, U.S. Treasuries are still the most widely held investment in the world and the U.S. dollar is still the world’s reserve currency. And, our

country is still considered a “safe-haven.” All these factors should help mitigate the consequences of the credit downgrade.

Optimism

Although the economy has slowed down in the first two quarters of 2011, there are several reasons to stay optimistic. Despite the fact that consumer debt is still a large problem in most households, many have made serious steps towards balanced budgets by cutting down credit-fueled spending and paying off debt. Personal debt-to-income ratios have improved drastically and savings are up.

In addition, many corporations are sitting on huge amounts of cash and their balance sheets look leaner than they did before 2008. Corporations continue to beat their earnings estimates and current P/E multiples and dividend yields also look favorable. This is not common during pre-recessionary periods. Recently, the Fed decided to keep the feds fund rate unchanged until at least 2013 to encourage spending and make it more affordable for consumers and businesses to borrow money. This is a very favorable policy from a consumer’s perspective.

Market Corrections and Opportunities

Although severe market corrections can be difficult to withstand, it’s important to remember that this most recent downturn is our first correction of more than 15% since the S&P literally doubled since March of 2009. Remember, if we didn’t have market corrections there wouldn’t be any “equity risk premium.”

Lastly, the recent “downgrade” has brought stock prices down to a level that creates a good buying opportunity. As there is no way to predict how equities markets will perform over the next few weeks or months, it is imperative to position your portfolio in a manner that sustains long-term growth. Diversification and rebalancing are the best techniques to control risk against unexpected events, but also take advantage of market drops. So, just when you feel like selling your stocks, you should consider rebalancing your portfolio by selling some bonds and buying more stocks. That’s exactly what we did for our clients last week.

Although most people classify roller coasters as fun, we’re not going to make that claim regarding financial roller coasters. However, our advice remains the same. “Please remain in your seat and keep your hands and legs in the vehicle at all times, unless you’re rebalancing!”

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