

2008 Again? — Why Today's Environment is Not the Same

Investors are certainly jittery today and have every right to be. In recent weeks, sovereign debt concerns have risen to the forefront, fears regarding a crash landing in China have circulated, economic worries relating to the massive Gulf spill have emerged, and disappointing U.S. unemployment results were just released. All of these events have culminated in the largest pullback in the equity markets since the rally began in March 2009 and the worst May since 1940. With the events of 2008 fresh in everyone's mind, we think it is important to put recent news into perspective and counsel clients and investors to not panic.

Is There More to the Headlines?

The disappointing economic news issued Friday, June 4, threw investors into a tailspin and put the kibosh on the first two-day rally in the S&P 500 since late April. While the jobs report headlines generated alarm, some positive news was buried in the data: manufacturing payrolls rose again (for the seventh time in eight months, hitting its highest level since May 2004), the manufacturing workweek hit its highest level in a decade, and aggregate hours worked increased. Importantly, these signs are in the manufacturing industry—an economically sensitive area—and signal faster economic growth. In addition, the May ISM Non-Manufacturing Employment Index rose above the break-even mark of 50 (a reading of 50 indicates that the economy is expanding, while a reading below 50 indicates that the economy is contracting) for the first time since the recession began in December 2007. Also, private labor income growth accelerated, providing support for consumer spending and a higher savings rate. While unemployment continues to remain at a high rate (9.7%), we believe that the U.S. economic recovery will continue, although the speed of the expansion going forward should soften somewhat. Softening growth is typical of a mid-course slowdown, which always occurs after a period of high-rate expansion, and acts as a relief valve that allows the expansion to enter a more sustainable, steady state.

The Dollar/Euro Zone Economics

The situation in Europe is cause for concern, especially considering the large amount of debt most developed countries around the world have incurred over the last several years. The media often points out that the European continent stands as a large trading partner of the U.S., however, it is important to put this statement into context. U.S. exports currently make up just 11% of GDP, which is less than any of the other G7 nations. What's more, the U.S. sends just 17% of all of its exports to the euro zone, meaning that only 1.7% of U.S. GDP is exposed to the dollar/euro rate. Also, a stronger dollar should have a deflationary effect on the U.S. economy and should help keep interest rates low for the foreseeable future.

Today investors are asking if Europe's sovereign debt crisis is similar to America's subprime mortgage crisis. During 2007, as the subprime mortgage problem first emerged, it was widely deemed to be manageable and containable; however, its contagion effect was significantly underestimated. It is no wonder that investors are now skeptical of reassurances from government officials. An important difference exists between today's financial crisis in Europe and the one that occurred in America in 2007-2009. In the U.S. event, subprime mortgages were converted into AAA credits by incorporating them into Collateralized Debt Obligations (CDOs), which became very popular collateral. When home prices fell, these securities turned out to be blind pools. The value of these CDOs collapsed as collateral plunged because the subprime credits held within the structure could not be accurately determined. Even a small amount of exposure to a contaminated security caused all blind pools to become toxic. While no one wants to underestimate the potential of the latest financial crisis, the blind pool problem does not seem to be an issue in the European sovereign debt crisis and thus the probability of a widespread global contagion is significantly less.

China's Economy

Many strategists are also waving the red caution flag over signs that the Chinese economy is slowing. In reality, recent signs of a softening Chinese economy are actually good news rather than bad news. Weaker growth means that the government's campaigns to stem real estate speculation and slow the economy are working. It would be a very bad signal if China's economy continued to exhibit inordinate strength or overheat; the result could provoke much harsher government intervention with very unpredictable consequences.

The Health of U.S. Corporations

It is important to keep in mind that U.S. corporate profits are on the rise and most corporate balance sheets are solid. In fact, U.S. corporations are sitting on approximately \$1 trillion in balance-sheet cash—the most since 1952, when adjusted for inflation. The high cash balances enable significant flexibility for companies that bodes well for investors in several ways: (1) they are much less reliant on the equity and debt markets for capital, (2) they can buy back shares and/or raise dividends, and (3) they can make acquisitions. These dynamics were not in place in 2007, when we entered the most recent recession.

Insider Buying

Earlier this year corporate insiders went from being heavy sellers of stocks to buying as aggressively as they did at the bottom of the market in 2003. Corporate insiders are not short-term traders and clearly see value in many of their shares at today's price levels as well. For example, the majority of oil-related stocks have seen their share prices decline substantially since the BP oil spill occurred. Regardless of a company's actual exposure to the accident in the Gulf of Mexico, shares of oil-related companies have been sold relentlessly since the event took place. Schlumberger (SLB) shares have declined 22% since April 30, even though the company only derives approximately 12% of its total revenues from resources located in the Gulf. Bottom line? The need and demand for oil is not going to disappear, thus drilling and exploration will occur in other areas. To that point, SLB insiders apparently believe that the stock may be oversold as they have begun buying stock for the first time since October 2008.

Portfolio Positioning

In our client portfolios, KING owns stocks in companies that have very attractive financial characteristics and should fare relatively well in a choppy and turbulent environment. Most of our holdings have strong balance sheets, low P/Es or other financial metrics, and possess solid or unique franchises. While not all client portfolios own the same stocks reflective of differing client investment objectives, many of our clients own positions in certain healthcare stocks which have between 30% to 50% of their market capitalizations in cash and trade at a multiple of 8x or less of 2010 earnings estimates. These stocks pose little risk in our opinion, but offer very nice rewards over the long term. In addition, we are finding some commodity-oriented stocks that are trading at less than 10x earnings and have exposure to industries in which we believe demand is poised to accelerate over the next 12 to 18 months.

Final Thoughts

Global equity markets are being pulled by the clash of two opposing forces. On the positive side, there is continued economic expansion around the world, improving corporate profits, very low interest rates, and a diminished threat of inflation over the near to intermediate term. On the negative side, Europe faces mounting growth problems, an intensifying debt crisis, and the concern that banking fragility could cause a credit squeeze. We believe that the battle between these two opposing forces will continue to create volatility in the market over the near term as has been evidenced in recent weeks, but that the disciplined investor will eventually be rewarded.