



# Market BULLETIN

May 2010 Market Bulletin

## The Global Macro-Economic Backdrop

**R**ecent events in Europe, particularly in the ailing countries of (in order of the magnitude of their problems) Greece, Portugal, Spain, Italy and Ireland have highlighted the debt headwind that the developed world faces as it attempts to rebound from the depths of its first synchronized recession.

While it was an overindulged consumer (particularly in the U.S. housing market, but also in Great Britain and much of Europe) that tipped the world into recession, exceptionally low short-term interest rates, unprecedented and extraordinary levels of central bank liquidity and good old-fashioned government deficit spending combined to stop the downward GDP spiral and put the world back on a path towards average growth.

But if drinking up too much consumer debt at the credit-market sub-prime party caused the world to fail its sobriety test a year ago, too much government debt today seems to be a cure leaving us with a monumental hang-over. While consumers around the globe have rationally retrenched, sovereign debt levels have finally reached a psychological peak for at least those countries with marginal economic and demographic prospects going forward.

So what does all this mean for the world and financial markets in general?

**In the simplest terms** the developed world (think U.S. and Europe) was living beyond its means and pulled a lot of its growth forward by borrowing money from a developing world (think China and India) that was saving more than they were consuming. As such, now that we are forced to begin to attack our debt burden (slowly), we should expect:

- subpar growth relative to historical norms in the U.S. and Euro-area going forward
- short-term interest rates that remain lower for a longer time than most had anticipated
- slower growth that translates to a less than average return for financial assets, especially for fixed income investors, but better than average prospects in the emerging markets
- a downward pull, like gravity, on the Euro and dollar relative to hard commodity assets like gold and the developing world's improving currency situation

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- a materially higher tax burden coupled with some fiscal retrenchment as financial markets force politicians to address sovereign debt burdens over the foreseeable future.

**We do not think it means inflation** is about to spiral out of control, or that U.S. stocks are about to enter a longer term bear market. But at the margin, inflation and interest rates will have to be slightly higher than they would normally have been to attract the marginal lender to support our debt burdens. We would also warn those inflationary doomsayers that inflation is following its normal cyclical pattern as global levels of high unemployment, excess production capacity and an oversupply in housing are combining to drive prices for goods and services down throughout the developed world. And finally, we view the global equity retrenchment as a correction rather than a secular downward turn, and expect accelerating corporate profitability to gradually encourage additional employment which would be the final ingredient needed to sustain the nascent ongoing global recovery.

### **FIXED INCOME MARKETS**

As the stock market moved towards its bottom in March of 2009, bond investors flocked to the U.S. Treasury market, driving those yields to historic lows while riskier assets, particularly corporate and mortgage bonds, went begging. As financial markets began to heal, bond market investors took advantage of these historically wide credit spreads (the average investment grade bond had a yield of nearly 8% last year) and pushed risk spreads down. While that was great if you were fortunate enough to have participated in those markets (Our Commerce core bond strategy exceeded a cumulative 18% from the 3/9/2009 low through 5/21/2010), it stranded today's bond investor with exceptionally low interest rates and modest prospects going forward.

But the recent European troubles have pushed riskier bond investments back up in yield a bit, and we view this primarily as a buying opportunity for those who have government debt in their portfolios, particularly given our benign inflationary outlook and the recent steepening in the credit curve. We especially like emerging market non-dollar denominated debt and have been recommending this for our aggressive tactical investors. We are less encouraged by investment grade European debt and zeroed out our exposure to this relatively high quality sector with near perfect timing at the end of April. Finally we are sticking with our slightly shorter than benchmark allocation to duration/maturity as we expect the recent global headwinds to gradually fade and expect intermediate interest rates to gradually rise as the global economic recovery slowly unfolds. For those investors who participated in the riskiest sectors of the bond market over the past year, we expect at some point we will also recommend reducing your allocation to high yield, but would still favor the bank loan sector over the more typical high yield bond fund investment.

### **EQUITY AND ALTERNATIVE INVESTMENTS**

Just as everyone expected (but nobody ever knows when) the stock market as measured by the S&P 500 incurred its first 10% correction since rallying 80% from the market low on March 9, 2009. (These typically occur on average once every 11 months.) We entered the year thinking the major stock averages would likely trade in a plus 10% to minus 10% range for most of the year. Upside was probably limited by stretched Price/Earnings and valuation ratios which would likely decline as the year progressed, having discounted the strong earnings reports that were likely to accrue. We also thought the downside was limited to a typical 10% correction by the combination of upwardly trending global growth (particularly in the emerging markets), accommodative interest rates and declining credit spreads.



In early January the market took an initial 8% plunge as the debt problems in Greece and southern Europe were first digested, similar to this latest correction. Also fueling recent investor fears has been the decline in the Chinese stock market (falling since last August) as the Chinese government tries to slow economic growth and cool inflationary pressure. If the Chinese economy were to slow too much it would certainly call into question our global expansion story.

**And investors remain quite nervous** after the roller coaster ride they took over the last several years. Wild daily swings in the market averages over the last few weeks certainly don't help and have elevated the S&P 500 Volatility Index (VIX). Fortunately the recent drop in prices and this elevated sense of investor anxiety provides some upside potential. We would advise clients over the next several months to rebalance your equity exposure back to a more neutral exposure, selling stocks when the markets are up 5% to 10% on the year while remaining committed when the averages are down 5% to 10% for the year.

We have also recently advised reducing exposure to developed international investments because of the financial problems in Europe and to a lesser extent in Japan while maintaining our overweight exposure to emerging markets. We are also increasing the larger cap less risky stocks as we reduce our mid-cap sectors' allocation. Lastly we have added a 3% tactical increase in our alternative investments exposure at the expense of our overall stock allocation, emphasizing the commodity portion of the alternative investment universe, including precious metals.

#### **CONCLUSION**

The bottom line is to expect slower worldwide growth and some depreciation of the developed world's currencies relative to both hard assets and emerging market currencies. We think the dollar improves relative to the Euro and are emphasizing U.S. domestic investments over most of the developed world, reducing our international developed market exposure and zeroing out non-U.S. investment grade debt. We continue to emphasize both emerging market equity and debt exposure. Most importantly, we view the recent correction in the equity markets as long overdue, and that it is just that, a correction, not a change in the upward trend. But we continue to caution investors that the positive trend is relatively constrained as is the return from most financial assets by the overwhelming global debt burden we will be forced to digest and extraordinarily low interest rate environment we start with today.

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