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## Let's Make a (Debt) Deal ... and Crush the Market

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August 4, 2011

With the debt deal signed, the market has turned *all* of its attention to the economy and the European debt crisis. The result isn't pretty.

Don't let the headline suggest I'm making light of recent market action. It was an ugly day ... preceded by a stretch of only slightly less ugly days. We are now in official correction territory, with the S&P 500® index down 4.8% today and 12% since its recent high on April 29, 2011. It seems as if the debt deal that passed the House and Senate is a distant memory. The hope was that passage would relieve some of the market's ills, but clearly the market had had one eye, and now both eyes, on the economy and Europe.

This is the second 10%+ correction since the bull market began in March 2009, with last summer's swoon taking 16% out of the S&P 500. Since 1962, there have been 25 corrections greater than 10% during bull markets (thank you Lazlo Birinyi for the data). Nine of those 25 became bear markets (20% declines or more), which means 16 of the periods remained bull markets.

Put another way, based on history, there is a 64% probability that this is a correction and not the start of a new bear market. The average correction was 13.2% and lasted 118 days. If this market follows the pattern of the average 10% correction, the S&P 500 would bottom at 1184 in a couple of weeks. Hope springs eternal.

We've gotten yet another batch of limp economic news in recent days with weak personal income and spending earlier in the week; while we're still hung over from last week's hit to gross domestic product (GDP) growth for the first half of this year, and all of the recession's era. As a refresher, GDP barely grew at 0.4% in the first quarter and grew a paltry 1.3% in the second quarter. Today's initial unemployment claims were actually down and better than expected, but it wasn't enough to save the day. The market is waiting with bated breath for tomorrow jobs report, expectations for which are a gain of 85,000 jobs and no change in the unemployment rate.

### Technicals and sentiment

It didn't help that the S&P 500 crossed below its 200-day moving average earlier this week, which often begets additional selling by the technically-inclined traders. And today it was all about high-volume momentum, which begets selling. By the close, the selling had become indiscriminate and anything with a risk profile was being dumped. Even gold—which had been on a tear—didn't escape the carnage. After the big selloff on Wednesday I wrote that we would at some point get to a sufficiently oversold level with over-bearish sentiment conditions, but that we wouldn't venture a guess as to when. Clearly that was not today and it's never a good idea to try to catch a falling knife.

Eventually a bottom may be found with extreme pessimism, given that at extremes, sentiment is contrarian in nature. As of the close today, the volatility index (VIX) shot up eight points to over 32, but most technicians would like to see 40 to signal true heightened worry. The two-year Treasury note traded at a record low yield as investors fled for its safety (ironic given that Treasuries still face a possible credit rating downgrade).

The ratio of New York Stock Exchange (NYSE) advances to declines (A/D) and upside to downside volume was extremely lopsided, suggesting major anxiety. Volume overall was extreme as well. Bullishness among the American Association of Individual Investors is now down to near where it was in March 2009, at the bear market's end. And the Crowd Sentiment Poll by Ned Davis Research (NDR) is deep in extreme pessimism territory. Fear is back!

### **Double-dip?**

All of this is only adding to the angst about a potential double-dip recession, and the loss of wealth from the stock market over the past nine days doesn't help either. We are never dogmatic about our outlook and I will admit that my hope for a lift in the economy as the year progresses has had a heck of a lot of cold water thrown on it. Although the market no longer seems focused on the debt ceiling, there is no question that the hit to confidence that came as a result of the torturous negotiations is not dissipating any time soon.

It wasn't only stocks that moved dramatically, but bonds, too. The yield on 10-year Treasuries dropped to 2.42%, reflecting the "stall speed" at which the economy is presently operating, as I noted in my report posted last week ("Disappearing Act"). That represents a level of growth low enough that the economy risks losing all remaining momentum and falling into a recession. Of the last 11 recessions, nine were preceded by at least one quarter of GDP growth below 1% in the year before the recession began.

However, low-growth quarters don't always mean pending recession. In the post-World War II (WWII) period, there have been 25 quarters with GDP growth of less than 1% and only 12 of them (as such, less than half) signaled the beginning of or a coming recession.

### **Maybe not**

How and why might a recession be avoided? Here are the positives we're left to hang our hats on:

- Soaring corporate profits and healthy capital spending (11% of GDP)
- A renewed downturn in initial unemployment claims (to a level that suggests 2.5-3.0% GDP growth)
- A very steep yield curve (inversions have preceded every post WWII recession, although that's much less likely this time given a 0-0.25% fed funds target range)
- Pent-up demand, especially within the auto sector
- A weaker dollar, which is boosting exports (13% of GDP)
- The worst of state/local spending cuts may be behind us

As per the last bullet, Ned Davis Research has a recession probability model that's based on state conditions and it currently has a low 5% probability of a recession. However, the data is only monthly, so the next reading could see an uptick.

### **QE3 to the rescue?**

Also being mulled is the reaction by the Fed to the latest economic sluggishness. In the last two days, several Fed officials have suggested QE3 is necessary. Expect the chatter to gather volume as we approach the Fed's annual meeting in Jackson Hole this month. Recall it was at that meeting last year that Ben Bernanke first telegraphed QE2. For what it's worth, PIMCO's Bill Gross believes Bernanke will indeed hint about the possibility of QE3.

We continue to think the bar is high for QE3, but they will certainly be discussing what weapons remain in their arsenal to aim at a struggling economy. After all, as recently as June, the Fed's published its outlook for the economy and forecast 2.7-2.9% growth for this year. That now appears to be a stretch, even with the Fed's expected lift toward the latter part of this year.

But there are other things the Fed can do besides QE3. They could lower the rate they pay banks on excess reserves in order to free up more lending liquidity. They could make a stronger pledge to hold their balance sheet at its record high and the fed funds rate at its record low for an even longer "extended period."

### **Across the pond**

It feels like Groundhog Day with regard to the European sovereign debt crisis, with confidence (or lack of it) in the driver seat. Portugal didn't need a bailout based on fundamentals, but was forced into a crisis when confidence broke regarding European policymaker's ability to provide sufficient solutions.

Policymakers gave the bailout fund increased flexibility but failed to give it more ammunition, leaving it unable to address problems in Spain and Italy, if needed. The bailout fund needs to be sufficiently large to provide markets confidence that any possible crisis can be dealt with.

Italy doesn't appear to need a bailout on the face of things. While it does have the third largest debt-burden globally, it has significant differences relative to the other peripherals: a fiscal surplus before factoring in debt service, high levels of domestic ownership of its debt, no housing bubble and long maturities for its debt. However, the rolling confidence crisis has crept into the Italian market, and once confidence is breached, it is difficult to repair. Even Italian banks, traditionally stalwart holders of Italian government debt, have started to reduce their support for Italian debt. Additionally, depositors are slowing pulling out of peripheral banks, worsening the capital situation for the banks, which need more capital to insulate themselves from future crises.

Meanwhile, the increased flexibility of the eurozone bailout fund, in particular its ability to purchase Spanish and Italian sovereign debt in the open market, as well as ability to assist banks across the eurozone, isn't yet active. The changes need to be voted on and approved by individual nations' parliaments, which are generally on summer holiday for the rest of August. Even the European Central Bank in its reported purchases of only Portuguese and Irish today, fails to add confidence. This general lack of urgency by policymakers in Europe is adding to confidence woes.

Until more forceful and credible solutions are put forth, European banks and sovereigns will continue to be under pressure from this crisis of confidence.

### **Global synchronized slowdown**

Purchasing manager surveys globally fell into areas that were either near contraction or into contraction in July. While one month's of data does not necessarily indicate a trend, the synchronized nature of these readings indicates that global growth expectations need to be reduced. Additionally, export data from Korea and Taiwan indicate that the Japanese supply chain disruption is not the only reason for slowing, as they show broad based weakness across product types.

### **What's an investor to do?**

Acting in haste in the midst of panic is rarely a good strategy in the longer-term. We know the global economy was hit with two major shocks, long before our elected leaders in Washington dealt their own shock to the system. The former two would be the disaster(s) in Japan and the huge spike in oil prices from December through April. Both of those are now receding. And although our politicians are receding to their recess, the hangover to confidence of what their antics (including using dire forecasts to make their points) have created doesn't seem to be in recess.

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(0811-5078)