

August 2011

From Denial to Despair (and Back?)

Ronald Temple, Managing Director, Lazard Asset Management

In this commentary, we offer our perspective on the longer-term backdrop for the events of recent weeks as well as the key elements of uncertainty ahead of us. First, we review the transformation of the role of government through the financial crisis from an overseer role to a backstop capacity not only for markets but also for the economy. This ever-increasing involvement factors into the current despair as investors are beginning to realize that one of the legs supporting the economic stool is about to be taken away, and to some degree might be unavailable in the future. Put another way, the government was able to bail out the system in 2008 and 2009. Now the financial system is unwilling to finance the bailout mechanism which means the left-tail potential for markets is more extended than many investors can stomach. This view of government impotence has been vying with the view that there are still many more tools at central bankers' disposal. This back-and-forth is to some degree the reason for the severe swings in markets as the optimists battle the pessimists. Below we summarize some points that either side of the tug-of-war would make and then quickly address investment implications.

The Backdrop to the Current Turmoil

5 Years (in a Few Paragraphs) that Set the Stage for Today

The financial crisis became identifiable as early as 2006 when we began to learn of consumers failing to make even the first payment on their mortgages. In 2007, we witnessed the beginning of the end for Bear Stearns along with wholesale funding market access to a wide range of financial institutions. At the same time, we began to witness unprecedented actions by the U.S. Federal Reserve (the Fed) to replace wholesale funding through a wide range of relief programs. In 2008, yet again, the crisis embroiled markets with Bear Stearns ultimately being absorbed by JPMorgan Chase and, after only six months, they later absorbed Washington Mutual. We also saw the end of Wachovia and Lehman Brothers and watched Fannie Mae and Freddie Mac go into conservatorship. As in 2007, government involvement in holding the system together grew through the year with new funding facilities to support broker-dealer funding, commercial paper markets, money market funds, alongside the Troubled Asset Repurchase Program and its child the Capital Purchase Program (the program in which the U.S. Government purchased preferred equity from the nine "too big to fail" financial institutions). Late 2008 and early 2009 represented the crescendo of the financial crisis that began to wind down with a range of programs such as the Making Home Affordable Program and the stress tests that were used to force banks to raise private capital.

The above events highlight that throughout the crisis, the glue that held the system together was government and central bank intervention. The one thing that gave investors confidence that they would not necessarily be wiped out was that there was a government backstop. The backstop was not set up to save investors as much as preserve the underlying economy that drove investor capital allocation decisions.

The government also became more pivotal in supporting real economic activity through fiscal stimulus measures. The crisis brought to light the extent to which consumers and financial companies had engaged in a borrowing binge, taking debt-to-GDP ratios to unprecedented levels. The deleveraging process began in 2009 in the United States with debt-to-GDP peaking at 365%. It has declined by over 2500 basis points so far. Household debt has declined from 98% of GDP to about 88% in eight quarters, an impressive feat except for the fact that over half of the decline is due to defaults and write-offs of debt. The financial sector has deleveraged from over 120% of GDP to 94%.

The only reason that real GDP has not declined substantially is that the government replaced the consumer as the primary borrower in the market. Annual government deficits in the United States topped 10% of GDP, taking total government debt-to-GDP from 64% to 80% in the two years to the first quarter of 2011. The government borrowing was not simply burned or wasted (contrary to popular opinion in certain political circles). The table below from the Office of Management & Budget summarizes the biggest contributors to the government spending:

	2008	2011e
Total Outlays	\$2.98 trillion	\$3.82 trillion
Defense	\$700 billion	\$910 billion (includes veteran's benefits)
Medicare and other Health	\$672 billion	\$882 billion
Social Security	\$617 billion	\$748 billion
Interest on the debt	\$253 billion	\$207 billion
Unemployment Compensation	\$45 billion	\$135 billion (peaked at \$160 billion in 2010)
Education, Training...	\$91 billion	\$115 billion (all of the increase is to states for schools)
Nutritional Assistance	\$60 billion	\$107 billion (over 45 million Americans receive food stamps)
Housing Assistance	\$40 billion	\$69 billion
All other	\$502 billion	\$647 billion

The reason all of this background matters is that it appears that governments have now reached the end of their borrowing binge capacity, as investors increasingly question whether they will ever be repaid. This is not the place to discuss the many differences among the countries in Europe facing problems much less the differences between the United States and Europe. That said, the common theme across both continents is that the ability of government to inject further stimulus appears to be at an end. In fact, the government in most countries appears set to become a headwind to consumption and growth after sustaining economic levels for almost three years.

The fact is that governments in the developed economies in the West are now in contraction mode. This fact is part of why the markets have been so violent in recent days. The other key driver is that investors finally seem to be realizing that we are in the midst of a sustained, multi-year deleveraging process. If the government can no longer support consumption through transfers to the poor or through a tax code that is generating the lowest amount of tax revenue relative to GDP in 60 years, the private sector will have to carry the weight with even less of a lift from government. The challenge for the private sector is the lack of end-market demand as consumers continue trying to repair their balance sheets.

We do not see much reason for unrealistic optimism in the near-term. As I wrote in the [Second Quarter 2011 U.S. Outlook](#) piece the single most important asset for American households between the 25th and 75th percentile of net worth is their home. For the top quarter of Americans by net worth, their biggest assets are their ownership of private businesses and financial assets. The first group has recently seen home prices hit a new low. The latter group with financial wealth has just taken a psychological blow in the markets. It would be unwise to expect a surge in economic demand from these consumers.

Riding the Psychological Rollercoaster

Appreciating that we face several years of ongoing private sector deleveraging and a contraction of government, we can begin to understand why the market has been convulsing in recent days. In our view, investors are engaged in a classic battle of fear versus greed.

If I could summarize the challenge facing markets:

1. Bulls would highlight:

- a. Strong corporate earnings in this season to date, even if the growth rates were decelerating. Revenue for the Standard & Poor's ex-financials Index (S&P) was actually up on average by 15% from a year ago with Earnings Per Share (EPS) up 20%. The United States and euro zone countries might face issues, but the companies are doing very well in spite of these sovereign challenges.
- b. The Fed's commitment to lower for longer and its willingness to consider other easing tools. Perhaps Quantitative Easing 3 (QE3) is right around the corner. With or without QE3, the Fed has offered a stark choice between zero returns on cash or investing in riskier assets.
- c. The European Central Bank (ECB) is beginning to accept its need to monetize debt and bridge the gap to the European Financial Stability Fund (EFSF) formation which will also be a bridge to further economic and fiscal integration. The sharp decrease in yields in Italy and Spain has pulled them back from the brink and the speculators have been burned.
- d. Fuel price declines are a positive for consumers who are effectively getting a tax cut.
- e. Budget deficit negotiations might well have just gotten a tailwind from the downgrade. (This is a stretch in my view.)

2. Bears would highlight:

- a. The European fiscal situation is anything but resolved. There are too many contingencies that have to be resolved and the public is not in favor of the steps that are going to be required.
- b. As highlighted by Standard & Poor's, "The downgrade reflects our view that the effectiveness, stability, and predictability of American policymaking and political institutions have weakened at a time of ongoing fiscal and economic challenges to a degree more than we envisioned when we assigned a negative outlook to the rating on April 18, 2011." This statement summarizes this bearish point quite well on its own.
- c. Taxes will go up and government spending will decrease, reducing aggregate demand and GDP substantially. These declines in GDP will likely lead to even more need for cuts, which risks getting us into a vicious downward spiral.
- d. Deleveraging has only just begun and it will not be easy.
- e. Earnings growth is slowing and expectations are too high.

With these positive and negative perspectives in mind, the last week or two of market moves make a lot more sense.

Investors learned on July 29, 2011 that the U.S. economy was much weaker than previously believed in the first half of the year. Real GDP registered a barely positive 0.4% increase in the first quarter of 2011 (versus the previously reported 1.9% growth rate) and only 1.3% in the second quarter (versus an expected 1.8%). Surprisingly, the market reaction to this news was relatively muted. In fact, the S&P 500 Index closed July 29, 2011 at 1292, only 6% below the year's high, which was itself the highest level in almost three years.

This market resiliency was even more surprising at the time, in light of the ongoing brinksmanship in Washington that still threatened to shut down a substantial portion of government operations. Shockingly, the potential for a government default, though highly unlikely, had not even shaken markets. Even short of a default, we had indicated on our [July 27, 2011 Market Update call](#) that our base case scenario of an inadequate deficit reduction deal and the likely ensuing credit rating downgrade did not appear to be priced into the markets. The prospect of not reaching a deal and the resulting economic havoc of a partial government shutdown (spending would have had to be reduced by about 40% to avoid incremental debt issuance) was definitely not priced into risk assets.

On Friday evening, August 5, 2011, S&P issued its downgrade notice. While we believe there was legitimate reason for markets to slide on Monday, the degree of the decline was surprising considering that S&P had warned explicitly on July 14, 2011 that it would downgrade the rating if the United States failed to agree to a \$4 trillion deficit reduction plan. We had worried that investors were complacent regarding the U.S. deficit situation through the entire debacle and only began to assess the implications over the subsequent weekend. It appears to us that the downgrade was merely the proverbial straw that broke the camel's back and represented a culmination of a series of negative news events that the market had attempted to shrug off.

The realization of the consequences of a downgrade on consumer and business confidence combined with the GDP weakness in the first half was aggravated even further by the news that AIG was suing Bank of America for \$10 billion over alleged misrepresentation of

mortgage backed securities sold by Countrywide and Merrill Lynch. This litigation raised fears among bank investors that we might face another capital raise from Bank of America and forced selling of assets such as the stake in China Construction Bank even while there is meaningful supply of bank shares still ahead of markets in Europe and China. Ultimately, the preponderance of evidence argued that investors' expectations for sustained economic growth might simply have been too optimistic.

In our view, the violent decline also reflected a very important realization among investors that there is very little that government can do to help the economy and markets if we have reached the end of our fiscal stimulus capabilities. While there are very clear ways in which the government could encourage and even directly create jobs, investors reached a state of despair as they contemplated the potential long-term deficit implications of any ideas involving government spending. Looking through the lens of the European sovereign debt crisis, it felt as if the last life preservers had been used, and the S&P 500 Index ended the day down 6.7%.

It is interesting to note that investors basically ignored the ECB's announcement on Sunday evening that it would "actively implement the Securities Market Programme" and its subsequent purchases of somewhere between €4-5 billion of Italian and Spanish government bonds on Monday. These transactions were very important in that they were the first purchases of bonds issued by nations other than Greece, Ireland and Portugal. The surprise purchases, though small, were enough to push Italian 10-year yields down by 80 basis points on Monday and a further 20 basis points through Thursday. Spanish yields were down by a like amount. The magnitude of the declines was perhaps exaggerated by the lack of volume in August and the lack of any new refinancing supply from either nation until month end, but the implications were still important as it relates to choices available to policy makers to address European sovereign concerns. Our understanding is that through Thursday morning August 11, 2011, the ECB has deployed only €10-15 billion for bond purchases, but to great effect.

On Tuesday, we were somewhat surprised yet again by the magnitude of the market reaction to the Federal Open Market Committee statement which read in part:

"The Committee currently anticipates that economic conditions--including low rates of resource utilization and a subdued outlook for inflation over the medium run--are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. The Committee also will maintain its existing policy of reinvesting principal payments from its securities holdings. The Committee will regularly review the size and composition of its securities holdings and is prepared to adjust those holdings as appropriate.

"The Committee discussed the range of policy tools available to promote a stronger economic recovery in a context of price stability. It will continue to assess the economic outlook in light of incoming information and is prepared to employ these tools as appropriate."

Initially the S&P 500 Index sold off on the release, perhaps as investors focused on the statements regarding weakness. Perhaps there was still an inkling that the Fed would reassure markets by saying growth would resume after the disruptions of the Japanese earthquake are behind us and other short-term issues have been resolved and were disappointed to see a negative prognosis instead. Then, in an abrupt and surprising attitudinal shift, investors focused on the Fed as the backstop for markets. The not so subtle message from the Fed was that investors have a choice that will not change anytime soon: take risk or earn nothing. Even though investors had ignored the ECB's actions on Monday, the Fed's statement revived their spirits.

The S&P 500 Index proceeded to rally 6.5% from the lows of the day to close 4.7% above the prior day close (but still down over 2% from the Friday close). What was surprising to us was that anyone truly suspected the Fed was even close to considering raising short-term interest rates and/or allowing its securities portfolio to begin to run off.

On Wednesday, we faced another bout of depression and despair. After seeing some strength echoing overseas after the U.S. market close, rumors surfaced about French banks facing funding strains (these rumors are not entirely new) and of a potential downgrade of France from its AAA-rated long-term credit rating. The latter rumor made little sense given that S&P had reaffirmed the rating on Monday (and again on Wednesday) and that the major ratings agencies have not even placed France on watch. Where the rumors did make sense is that the credit default swap markets showed an elevated risk of default for France. Of the AAA-rated countries, the cost of buying protection in the CDS market is highest for France at 175 basis points. This compares to Germany at 86 basis points and the United States (which is now AA+) at 53 basis points. If France were to lose its AAA rating, there is a real risk of a euro zone crisis of much more severe proportions than we have seen to date as the EFSF relies on AAA-rated nations to back the issuance of its AAA-rated bonds which then fund sovereign bond purchases in the periphery.

Beyond the European situation, it seemed as if investors had time to realize that the news from the Fed, while more specific and long-term than they might have expected, was not as meaningful as they had interpreted initially. At the end of the day, after substantial volatility, markets closed near the session lows, down 4.5%.

As we moved into today, the rumors regarding French banks continued to trouble markets. Société Générale was particularly in the spotlight on Wednesday, falling 15% on negative rumors. It issued a statement disavowing any issues related to its earnings or funding, but the shares fell as much as 8% this morning along with peer banks as rumors of Asian banks cutting/reevaluating lines are surfacing. A factor compounding the fears around French banks is that they have been among the most dependent on U.S. money market investments for their U.S. dollar funding.

Ultimately, the takeaway from Wednesday and Thursday morning so far has been that the problems in Europe have not been solved and might be growing in spite of central bank intervention which can only be a short-term bridge to a real solution.

Investing Against a Backdrop of Uncertainty

In an environment with this much uncertainty, there are wide ranging investment implications. The market this week has appeared to be in an indiscriminate risk-on/risk-off situation. Security selection might not have seemed very important, but when we have gotten beyond the immediate whipsaw, we will likely see that there are serious divergences in performance. The good news of wholesale selling and buying is that it gives investors great opportunities to upgrade their holdings and to adapt to a new set of economic scenarios that might signal a need to reposition holdings.

We continue to see three long-term themes facing the United States.: deleveraging, re-regulation and widening gaps in society. Our view is that the systemically-driven choppiness is not entirely behind us and that we face a relatively lethargic economic outlook. With this view in mind, we see little immediate risk of inflation problems in the United States as measured by CPI. We also believe that interest rates are likely to be pulled lower by the Fed's actions with implications for yield curve shape and a range of credit markets around the (heretofore) risk-free curve. For example, consumers who are in a positive equity position on their homes may well see another chance to refinance their loans, with implications for mortgage backed security markets and lenders. We also see significant implications of the yield curve changes for a range of companies in the financial sector and beyond as low rates are not good for everyone and in fact are quite bad for many companies that rely on a net interest spread between their sources of funds and their loans and securities holdings.

At a high level, there are always opportunities in either the debt or equity asset classes, but the asymmetric risk/reward in debt at these yield levels is foreboding. Regardless of this view, we continue to believe that the best approach for investors is to focus on the equity and debt of companies with the strongest balance sheets, most robust organic cash flow, and the operational flexibility that results from those qualities. We believe there is more than enough sovereign risk in markets. There is no need to augment that risk by investing in highly leveraged companies with weak cash flow that might be unable to sustain themselves through the storm or might exit the storm permanently impaired. As such, the importance of security selection remains pivotal to protecting capital and compounding it when the storm ends.

Important Information

Published on August 11, 2011.

This commentary is being provided for informational purposes only. It is not intended to be, and does not constitute, an offer to enter into any contract or investment agreement in respect of any product offered by Lazard Asset Management, and shall not be considered as an offer or solicitation with respect to any product, security or service. The information and opinions presented have been obtained or derived from sources believed by Lazard to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions expressed herein are as of the published date, unless otherwise specified, and are subject to change.

© 2011 Lazard Asset Management LLC. Australia: Issued by Lazard Asset Management Pacific Co., Level 39 Gateway, 1 Macquarie Place, Sydney NSW 2000. Germany: Issued by Lazard Asset Management (Deutschland) GmbH, Neue Mainzer Strasse 75, 60311 Frankfurt am Main. Japan: Issued by Lazard Japan Asset Management K.K., ATT Annex, 7th Floor, 2-11-7 Akasaka, Minato-ku, Tokyo 107-0052. Korea: Issued by Lazard Korea Asset Management Co. Ltd., 10F Seoul Finance Center, Taepyeongno-1ga, Jung-gu, Seoul, 100-768. United Kingdom: For Professional Investors Only. Issued by Lazard Asset Management Ltd., 50 Stratton Street, London W1J 8LL. Registered in England Number 525667. Authorised and regulated by the Financial Services Authority (FSA). United States: Issued by Lazard Asset Management LLC, 30 Rockefeller Plaza, New York, NY 10112.