

Market Outlook

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'Til Debt Do Us Part

As of this writing, the world is waiting with bated breath for the outcome of the debt ceiling negotiations. Obstinate Democrats and Republicans are both playing a down-to-the wire game of brinkmanship and political will. Negotiations have been marked by round-the-clock reporting from Washington, acrimonious collapses of talks, and withering hopes that maybe crisis can be averted. Incredulously, the debt ceiling limit has brought us to within one week of the potential first-ever default on US Treasury securities. The negotiations have been so fractured and fluid that it is hard to know exactly what each side has on the table, or how close a default really is.

What is a default? A default occurs when an interest payment is missed, or principal repayment (e.g. a 90-day T-bill) can't be



paid. While there is often a grace period to rectify the default, even a short-term default can have very negative effects on the borrower's reputation. Hence, interest rates should rise to compensate future lenders to this less-than-reliable debtor. Those who dismiss default threats as scare-mongering and predict it would have little effect on the financial markets miss two points (in addition to the absolute shock factor this would cause). First, the reputational effects would be far ranging, driving up the cost (interest rate) to finance our debt at the very time we need "easy terms." Second, US Treasury debt serves as collateral for myriad securities and futures contracts, bank swaps, and derivative securities. If that collateral has to be marked down to recognize default, the chilling effects on the financial markets would make Lehman Brothers' collapse look like a hiccup. The "collateral damage" from this effect could be worse than default itself.

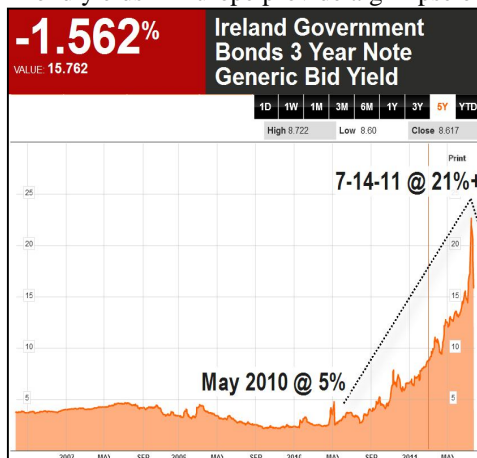
Investors seem nonplussed by all this fuss, however, as Treasury yields are still low and stocks have been bid up to their spring 2011 highs. In contrast to the hysteria being whipped up by the media, the US financial markets seem to have taken the possibility of default in stride. The quick recoveries from the

March (Japan earthquake) and June corrections have bred a sense of complacency, it seems. That complacency stems from the belief that the real probability of default is still near zero, or at least so low as to keep panic in check. If investors believed default to be imminent, a full fledged bear market would be under way. So if we are to take away the main message from the markets it is this: a default won't happen. Is this the wisdom of the crowds, or an example of fools rushing in where angels fear to tread? We'll know on August 3rd.

The inability to negotiate a "grand bargain" resolution to our US budget woes means that we will get only a short-term fix, a mere band-aid to staunch the core problems. The best deal will be to put off the day of reckoning, kicking the can into an election year where the Republicans hope to use it to their advantage. So while the immediate threat of default will pass, the lack of long-term solutions will add even more uncertainty to the tattered outlook of businesses and the unemployed.

The nail-biting countdown to raising the debt ceiling has pushed a much bigger problem off the headlines. The debt problems in Greece and the feared domino effect on other countries are something investors should watch closely, as the possibility of a Greek default remains very real. The second bail out of Greece has required investors to take losses (i.e. a partial default), and undermines the pretence that the EU would protect all comers. This raises the contagion risk to bond markets in Portugal, Ireland, Italy, Greece, or Spain (PIIGS). While Greece alone is a small country with a commensurate amount of debt outstanding, it is the contagion effects that can cause the most problems. Banks, hedge funds, and even the European Central Bank would have to take a write-down on defaulted PIIGS bonds, and with it would probably come the seizing up of the lending markets. For a world that depends on easy money to buy its way through the post-credit-bubble rehabilitation, a liquidity crunch would be most unwelcome.

Bond yields in Europe provide a glimpse of what danger will



look like in the US. Yields on PIIGS bonds have climbed as each chapter in the Euro debt saga has been written. While the "bond vigilantes" of the late 1970s may only be stirring from their slumber in the US, they are wide awake in Europe. Short-term Greek

yields have surpassed 25% and long-term have pushed to 18%, prior to falling after the latest bailout announcement. Moreover, a sudden jump in Italian bond yields, a new development, underscores the nervousness of investors. Bond yields are like the fever chart of the financial markets. As rates rise, they can signal trouble, and that is exactly what is happening in Europe. While seemingly forecasting a positive outcome in the debt ceiling battle, low US yields would telegraph trouble if and when they begin a persistent uptrend.

All of this seems to bring into question two bedrock tenets of finance. First, because it was always assumed US Treasury debt would never default, there has been no premium given to credit risk. Treasury bonds of all maturities serve as the benchmark for pure interest rate and inflation expectations, since there has been no credit (default) risk to account for, until now. While default will be avoided, simply lowering the US's credit rating, as S&P and Moody's have threatened to do, can create havoc in transactions that require default risk free bonds as collateral or the basis for calculation of other required returns. Secondly, Treasury obligations, especially the 90-day T-bill, set the discount rate for calculating the present value of dividends or earnings, which in turn helps calculate the fair value of a stock. With T-bill yields at a fraction of a fraction of one percent, the present value of an asset can approach infinity, or at least a ridiculously misleading present "value" for a stock that can hardly be viewed as fair. With the US economy and consumer in such a perilous state, unemployment remaining high, and debt weighing heavily on future consumption, these analytical tools may be misleading security analysts. While mathematically accurate, for practical purposes traditional models of valuation that depend on a normal, risk-free discount rate must be called into question by near zero yields and the dwindling of US credit quality.

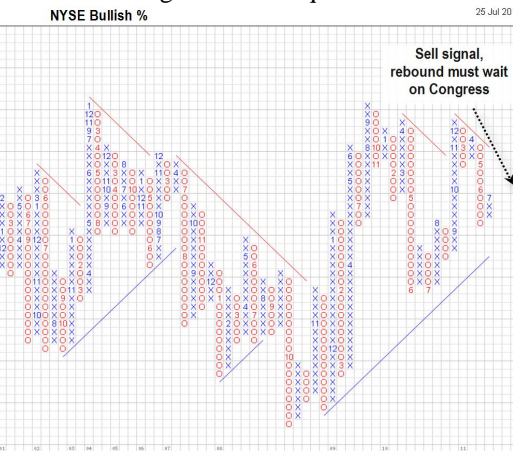
Stocks have been quite volatile since they peaked in May, and debt ceiling negotiations have lurched from hope to despair and back again. The strong earnings that had supported stock prices had been dealt a blow this summer as retail sales gained only slightly, factory use was stagnant, and export volumes fell. Unemployment actually rose in the past quarter, something almost unheard of this far from a recession's supposed end. All this had investors second guessing themselves, leading to a roller coaster ride that reflected the political fickleness in the capital.

Long-term tools help to provide some badly needed perspective at times like these, and ours are still urging caution, though they are improving. Key among these is the NYSE Bullish %, which measures the percentage of stocks on the NYSE that are on buy signals, using point-and-figure charts. It remains on a sell signal after having reached 70%-plus in the spring, a classic bearish formation. This indicator has improved since June, but the improvement has been weak. It is telling us that fewer stocks are able to give buy signals, the true measure of demand to own them. Unsurprisingly, with the debt ceiling hanging over them like the sword of Damocles, investors have been hesitant to buy.

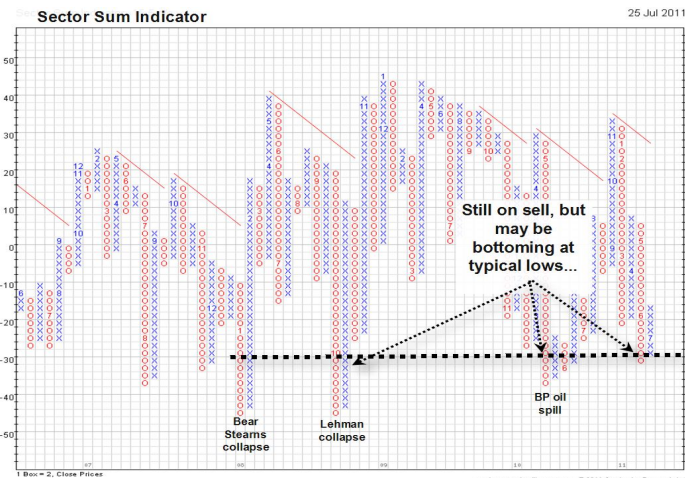
While the hedge funds and quick-buck traders are trying to scalp

nicks and dimes off stock prices, and ignore these broad trends at their peril, long-term investors are being warned to tread carefully.

The Sector Sum Indicator



tallies up the bullish buy signals of industry groups, and is then plotted on scale that ranges from -45 to +45. Like the NYSE Bullish % it tries to capture the broad actions on investors, rather than rely on the dime-a-dozen predictions of Wall Street. The message here, too, is one of caution—it is on a sell after having peaked at high levels over +30. However, this measure does look like it is trying to bottom at the low end of the range, a positive development. Should these indicators turn bullish, especially after a further sell-off, we would certainly raise client allocations to stocks.



We are maintaining a high level of cash in client accounts as we approach the 11th hour resolution of the debt ceiling debate. While it is inconceivable that the US would default, even for one day, the fact that we are within one week of D-Day with no signs of a debt deal is also incredible. The relative complacency of the markets tells us to expect the unexpected, for reality seldom satisfies the majority opinion on Wall Street. Our overarching strategy at this time is to protect our client's capital, as we are dealing with a fluid and volatile situation. Traditional analysis must give some weight to group psychology at this time, and given the short-term, vengeful thinking permeating Congress, we are not willing to blissfully assume a happy outcome. While we can expect a short-term stock rally when the immediate default threat is defused, action after that will determine how hot the remainder of summer will be for investors.