

# GYC Investment Update

## From the GYC Investment Desk

We know that some of you are feeling rattled and perhaps a little distressed over all the headline news about the global financial markets. Memories of 2008 are brought to mind as equity markets around the world have nosedived.

But one thing you need to remember – markets will move up and down. They will give you good returns over long periods of time but markets never move in a straight line. There will be huge up and down movements over that period. Also remember that the goal of journalists and financial reporters are to draw in readers, and sell their newspapers, magazine or newsletters; and nothing sells better than bad news! So expect to see sensational headlines like “Bloodbath”, “Massacre”, “Collapse”, etc. all of which are designed to provoke. On CNBC, Bloomberg and other news channels – almost everyone has an opinion about what is happening but few are really accountable for what they say.

That is why we prefer to focus on the data and what it is telling us. Although investors have been dumping risky assets in favour of safe havens, we think it is necessary to take an objective look at the situation and position our portfolios from there. The three main issues that the media has used to blame the recent sell-off are as follows:

### Reason #1 : US Credit Rating Downgrade

Investors fear a panic in the financial system would occur as the US loses its AAA rating, or that interest rates would rise, triggering a recession. However, market action shows otherwise. Despite fears of losing its AAA rating from Standard & Poor’s, demand for Treasury bonds actually increased, sending yields lower. Investors’ love affair with Uncle Sam’s IOUs remains unchanged. Furthermore, even if the other rating agencies like Moody’s and Fitch were to join Standard & Poor’s in downgrading US long term debt, it is unlikely that financial institutions would need to sell off their bond holdings and disrupt financial markets. Even with a AA- rating, financial institutions can continue to hold US Treasuries as risk-free assets and as part of capital reserve requirements<sup>1</sup>. We are unlikely to see a sharp sell-off in Treasuries or a rise in interest rates.



Figure 1: 10-year Treasury Note Yield Index

## Market Update

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## Reason #2 : Global Economic Slowdown

While it has been well conveyed to markets that the global economy has slowed significantly, investors need to remember that growth still exists. It is simply just moving at a slower pace. Of course a recession is typically preceded by slowing growth, but as we have highlighted in previous updates, with corporate profits and investment rising, the risk of recession is on the low side. Still, even if we are wrong and a recession springs up on us, it is unlike the market to act in such a fashion, losing 11% in a matter of days. It was also telling that stocks in defensive sectors fell like dominoes, which should normally rise in anticipation of a recession.

## Reason #3 : European Sovereign Debt Crisis

Despite announcing additional bailout funds for Greece and expanding the lending power of the European Financial Stability Fund (EFSF), markets grew jittery about the potential default by Italy and Spain. The nervousness may not be unwarranted as authorisation to expand the EFSF lending capabilities still requires national parliamentary approval. Hence, the EFSF has yet to purchase Spanish or Italian bonds, or extend credit to cash strapped governments.

Here is where the European Central Bank (ECB) steps in. It has announced plans to purchase Italian and Spanish bonds, in a bid to stop the contagion. This is effectively similar to what the Federal Reserve did in 2008, i.e. to use their balance sheet to stabilise financial markets. As a result, we should see European bond yields fall and the euro stabilise. However in the interim, as markets will have to depend on the ECB before the EFSF gain the relevant authority to kick the debt can further down the road, some form of volatility is expected.

## What next?

Policy action is crucial going forward. Should we get positive action to stabilise markets and stop the spread of contagion and raise confidence, it is likely that markets would rebound from current depressed levels. After all, financial markets are still some distance away from the panicky situation in 2008 and more recently, when the Greek problem first surfaced. Referring to Figure 2, TED spreads are still way below the levels when the subprime problems started surfacing.

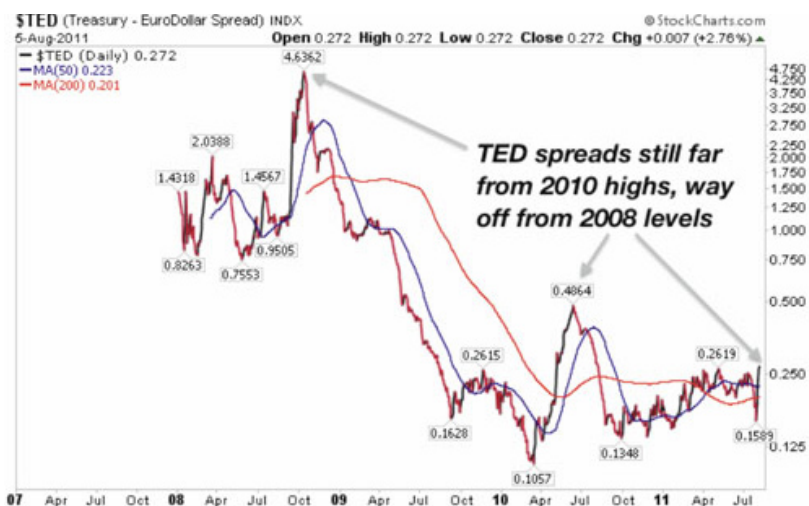


Figure 2: Treasury to EuroDollar Spread Index

Signs of better economic growth would be helpful to convince jittery investors that growth is only slowing, not stalling. Friday's US employment report provided some good news but was unfortunately overshadowed by the ratings downgrade. Jobs created were revised upwards in May and June, while July saw an increase in 117,000 jobs. Meanwhile, leading indicators like hours worked and manufacturing overtime continues to hold steady.

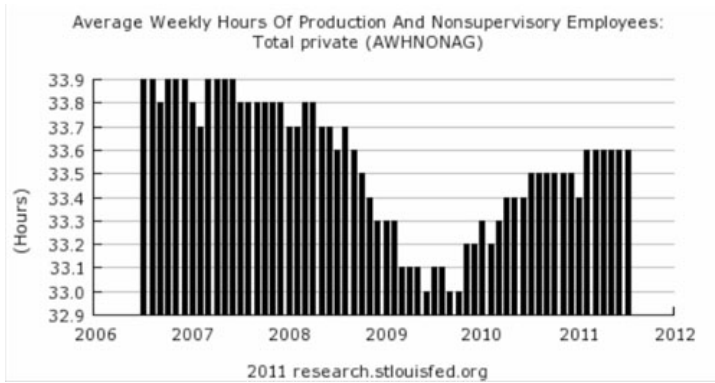


Figure 3: Average weekly working hours of Production employees

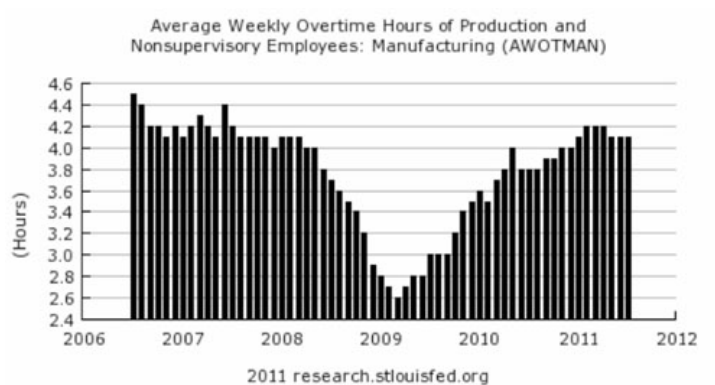


Figure 4: Average weekly overtime hours of Production employees

## Conclusion:

We remain mindful that events in Europe could potentially tip the scale either way. Given how depressed markets are, we are watching the data closely and will reassess if and when further de-risking of the portfolios makes sense.

On a personal level, you also need to remember why asset allocation (i.e. the amount you place in equities and bonds) is so important in investing. Having more cash in your portfolio means the less you are down this month, but also the less you made last year. Cash may seem like the best asset class to hold on to during times like these, but keeping cash over the long term actually earns you a negative return due to high inflation.

All of us are equally rattled by this market; red ink on the screen is hard to watch but there is no need to panic. We all need to keep calm, monitor the situation objectively and be ready to rebalance.

To find out how you can get started on your own investment portfolio, call or email us at:

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