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Thoughts About Today's Equity Market Selloff

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Following the Standard & Poor's downgrade of U.S. sovereign debt, our view — as expressed in our August 8 special edition of *Global Perspectives* — was that conditions were sufficiently unpredictable as to warrant a "trimming of the sails", especially out of equities. Though it was the downgrade that inspired this comment, we expressed equal concern about the difficulties facing the euro zone. Today's selloff in the equity markets, driven in part by stagnant economic growth in the euro zone and questions about the stability of the currency bloc's banking system, confirmed our fears.

The *Wall Street Journal* reported that federal and state regulators — including the Federal Reserve Bank of New York — have intensified their scrutiny of the U.S. operations of Europe's largest banks. Citing an unnamed official of a major European bank, the *Journal* said the New York Fed is "very concerned" about the prospects of European banks facing funding problems in the U.S. In other words, the Fed now feels compelled to protect the U.S. financial system from the possibility that strapped European banks could be forced to withdraw funds from their U.S. subsidiaries and affiliates. Though New York Fed Chair Dudley denied that any special attention was being paid to the subsidiaries of European banks, to us the Fed's actions represent a thinly veiled vote of no confidence in Europe's strategy to resolve its debt crisis.

The European Central Bank's (ECB) intervention thus far — primarily the purchase of Spanish and Italian debt — is viewed as a temporary solution at best. Meanwhile, concerns over fiscal solvency have weighed on consumer and business confidence in the region, leading to slower growth not only in the peripheral countries, but in France and Germany as well. Slower growth results in lower tax revenue and makes the fiscal situation even harder to resolve.

While the European banking system has begun to show signs of stress — the TED spread, which is the difference between three-month T-bills and Libor and considered a measure of banks' willingness to lend to one another, has trended higher throughout 2011 — banks continue to lend with one another freely, suggesting that we are far from a circa-2008 crisis. U.S. banks, for the most part, appear to be in decent shape, with limited exposure to Europe's problems.

All of the blame for today's fall cannot be laid at Europe's doorstep, of course, as U.S. data continue to disappoint. The consumer price index (CPI) rose 0.5% in July, much higher than the consensus estimate of 0.2%; higher prices are a headwind to consumption, which has been struggling to gain traction as it is. In addition, the Philadelphia Federal Reserve Index of Manufacturing Activity came in at -30.7, much lower than the expected +2. This is the worst reading since March 2009 and is at a recessionary level. Although the timing of the survey (right around the time of the debt downgrade) may have colored responses to some degree, it does not discount its message about the deteriorating state of the U.S. economy. One bright spot in today's economic data was a measure of leading economic indicators published by The Conference Board; coming in at an above-expectation 0.4% gain for July, the LEI, in contrast to the Philly Fed number referenced above, suggests that economy should continue to expand, if at a modest pace.

It seems clear to most investors that the ECB should ease aggressively and establish its own quantitative easing program. However, the central bank seems more concerned with fighting inflation than staving off recession. Meanwhile, the ability of the U.S. or most other developed countries to stimulate their economies is quite limited given the need for fiscal restraint. Overall, the markets are underwhelmed with the policy responses and wonder if policymakers really understand the seriousness of the situation.

Risks have increased significantly, and equity market volatility is likely to continue until we get transparent solutions to the debt problems of both the U.S. and Europe. But the catalysts for growth are many and significant, and these fundamentals will drive the longer-term performance of the market. In the meantime, a broad, globally diversified portfolio is the best way for investors to withstand the short-term volatility while positioning them to build long-term wealth. ■