

# Coping with Volatility

*James Spencer, CFA, Chief Investment Officer*  
*Maureen Kelliher, CFA, Senior Vice President*  
*David Walker, CFA, Vice President*

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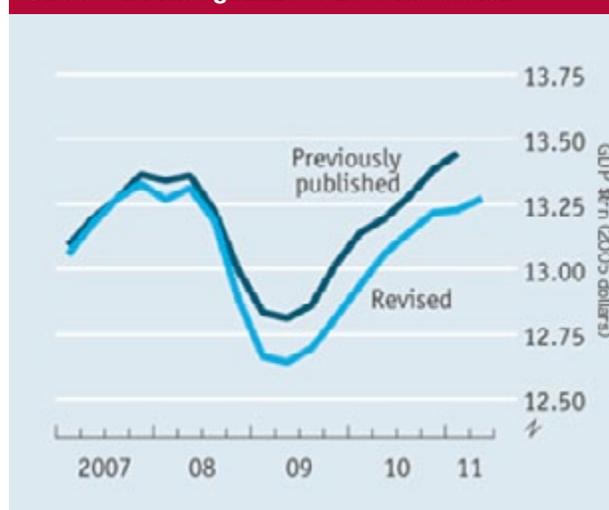
## Background

Early in 2011, investors had to deal with a spike in oil prices to nearly \$115 per barrel and the casualties and economic disruptions caused by the tsunami in Japan. The European debt crisis had been building for many months. Problems in Greece and Portugal, burdened by weak economies and government debt to GDP ratios approaching 100% or more, gave rise to suspicions about the financial situation in larger European economies – Italy and Spain. By August 3, 2011, the interest rate on ten-year borrowings in both countries jumped to over 6% from a range of 4-5% earlier in the year.

In the U.S. on July 9, the Bureau of Economic Analysis issued revised GDP numbers indicating that annualized growth in the first quarter was a tepid 0.4%, instead of the 1.9% reported earlier. The preliminary number for second-quarter growth was only 1.3%. Furthermore, revisions for prior years showed that the 2008-2009 recession was deeper than expected and that we had not yet recovered to the prior 2007 peak (see chart).

These revisions by the Bureau were followed by a release on August 1, 2011 pointing to a sharp slow-down in manufacturing activity, as measured by the Institute for Supply Management. July was the

On Second Thought...2008-2009 Recession



Bureau of Economic Analysis/*The Economist*, August 6, 2011

24th consecutive month of expansion for the U.S. manufacturing sector, “but at a slower rate of growth than in June” (ISM release, August 1, 2011).

The U.S. stock market dropped nearly 5% on August 4. After the market close on Friday, August 5, Standard & Poor’s reduced its rating on the long-term debt of the U.S. to AA+ from AAA. Given all of the preceding economic news, the rating reduction was enough to precipitate daily moves of greater than 4% in the stock market over the first four days of the following week.

## Coping with Volatility *Continued*

### What we are focused on

The U.S. stock market, as measured by the S&P 500 Index, is now down nearly 10% for the year and 17% from its recent high. Although there is much that is not right with the world, including economic growth that is lower than earlier expectations and its negative impact on near-term corporate earnings, equity valuations and dividend yields are attractive. Hence, unlike 2007 and 2008, when we were raising cash levels in our portfolios (because of both economic uncertainty and unattractive valuations), we have been using the current market volatility to look carefully for opportunities to deploy cash. We pay special attention to the following factors in reaching this conclusion:

- 1.** The weight of high levels of sovereign debt needs to be addressed and should result in a period of economic growth below that following previous recessions not characterized by such debt. Although the probability of another recession has increased, it is unlikely to be as deep as the recession of 2008-2009 (GDP in the fourth quarter of 2008 contracted at an 8.9% annual rate). U.S. banks are better capitalized than two to three years ago, and investors have a heightened awareness to today's risks.
- 2.** The rating agencies Moody's and Fitch recently affirmed their AAA rating on long-term U.S. Treasury debt (although Moody's assigns a negative outlook). These two agencies appear to have a predilection to wait and see how Congressional deficit-reduction negotiations proceed towards the end of this year before making a change.
- 3.** The intransigence strangling our political process and abrupt market volatility can shatter confidence and lead to rash investment decisions. In reference to the August 8-11 period of volatility, the New York Times reported in an online article, "Never before in the history of the S&P Index, which goes back to 1928, have there been alternating gains and losses of more than 4 percent in four days."
- 4.** The prevalence of high-frequency trading, more than 50% of all U.S. equity trading volume by some estimates, may exacerbate volatility and contribute to rising correlation among stocks during these periods of economic uncertainty.
- 5.** Year-to-date, bond portfolios have appreciated, providing some counter-balance to stock volatility.
- 6.** An ironic quote from former M.I.T. economist and Nobel Prize winner, Paul A. Samuelson, is worth remembering: "The stock market has forecast nine of the last five recessions."
- 7.** Corporate balance sheets are strong, dividend yields are high relative to bond yields, and dividend payout ratios still have room for expansion. Payout ratios are in the 35% range compared with 40-50% in the 1970-2000 period. The dividend yield on the S&P 500 is now 2.2%, in excess of that of the 10-year Treasury bond yield, which recently touched a 60+ year low when it dipped below 2.0%. Moreover, the common stocks of many large-capitalization, multinational companies such as Exxon, GE, and Johnson & Johnson are yielding 2.5-4.0%.



## Coping with Volatility *Continued*

**8.** The level of buying versus selling among corporate insiders has picked up, according to data reported in the August 22, 2011 issue of Barron's.

**9.** The P/E ratio on the S&P 500 Index is approximately 12x trailing earnings, compared with the long-term average of about 16x. Earnings would have to decline by more than 20% for today's P/E ratio to be even with the long-run average.

### CONTACT US

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In Massachusetts contact: Robert MacAllister, 617-441-1599, [robert.macallister@cambridgetrust.com](mailto:robert.macallister@cambridgetrust.com) ▶▶  
or William Yates, 617-503-4041, [william.yates@cambridgetrust.com](mailto:william.yates@cambridgetrust.com) ▶▶

In New Hampshire contact: Richard Simpson, 603-369-5104, [richard.simpson@cambridgetrust.com](mailto:richard.simpson@cambridgetrust.com) ▶▶

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