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This is Not 2008

The US stock market has been sick for the two months. The S&P 500 fell 14.32% in the quarter as persistent concerns over sovereign debt in Europe and job market stagnation domestically weighed on the market. Investor sentiment is very poor and stock markets globally have faltered. The one segment of decent returns over the past two years, commodities, has also succumbed to concerns over the global market outlook. The two best performing sectors in the quarter were utilities and staples, both highly defensive groups.

Many of the issues affecting global equity markets are genuine, yet the current situation is not likely a repeat of the disastrous 2008, which crippled global markets, produced sharp losses for stocks, and instigated a global recession. Going forward, there are sound reasons to believe the market will do substantially better in 2012 and that an improved US economy will support higher stock prices and valuation expansion from current levels. While it is foolish to predict a bottom or end to the disdain for stocks, investors are certainly pricing in the prospects of another recession and/or 2008 calamity. Once it becomes clear that Europe's sovereign debt problems are contained, if not fully discounted, and that the domestic economy is improving and global markets are rebounding, the potential gains should be strong. We encourage investors to remain calm while others capitulate. Here is why we think things look better going forward into 2012.

Global markets have struggled with the threat of inflation for the last few years. The combination of rapid growth in emerging markets, loose monetary policy in the US (effectively exporting inflation abroad), and increased speculation in commodities by investors searching for an asset class alternative to stocks or bonds, has fueled inflation globally. Higher commodity prices have also increased prices paid for raw materials by manufacturers in the US. Consumers have borne the weight of higher producer prices by paying more for most items. This has thwarted stimulus efforts, frustrating the Fed. The weaker dollar, a byproduct of US monetary actions over the past year, has exacerbated these problems. And while a weaker dollar may help the segment of the economy that depends on exporting overseas, the reality is that the United States is a consumer society that relies on inexpensive imports. Economic improvement is therefore difficult to attain with rising inflation and loose monetary policy "for an extended period" as per the Fed. Inflation however, appears to be peaking worldwide and is setting the stage for more effective monetary policy, global easing, and higher stock prices.

Oil nearly reached \$115 a barrel in early May 2011 and has since dropped to \$78, a decline of 32% in less than 6 months. The CRB Index, a measure of broad commodity prices, has dropped 12% over the same time period. Gas prices for consumers are dropping with unleaded gas now averaging \$3.39 a gallon compared to \$3.98 five months ago. Inflationary pressures are easing. Recent strength in the US Dollar, due to a flight to quality from fear over the debt crisis in Europe, has helped continue the decline in dollar denominated commodities which suffer when the dollar strengthens, and in turn, lead to inflation. Lower inflation is good for stocks, their earnings, the consumer's purchasing ability and should allow for valuation expansion from already depressed levels.

Consumer discretionary stocks have been one of the more resilient sectors of the US economy, gaining 4.5% over the last year despite the poor economy and inflation concerns. When the stock market presents an anomaly, it is usually worth paying attention to. While the economic picture is lackluster and financial problems in Europe dominate markets, the consumer stocks have quietly outperformed. Could it be the consumer isn't as bad off as feared? Or is the sector anticipating the decline in inflation and an improving economy going forward?

Irrespective, their performance bodes well for stocks in 2012. Interestingly, this anomaly also occurred in 2008 despite what was described as massive consumer deleverage following the “Great Recession.”

The 2012 presidential election has the potential to rally the stock market. Regardless of who wins next November, the market typically anticipates the outcome and any change in policies six to nine months before the election. This suggests that come early 2012, investors should begin to anticipate a better environment for stocks. Both parties want to improve the economy, but little is likely to be accomplished during the run up to the presidential election and negative rhetoric will remain high. Once over however, efforts to reduce many of the uncertainties facing businesses will benefit the market. Too many questions for businesses remain over health care costs, taxes, and seemingly perpetual unemployment benefits affecting job growth.

Seasonal factors should also not be ignored. The fourth quarter tends to be a strong seasonal period for equities. The holiday shopping season, year-end budget flushes, rebounding from Q3’s seasonal weakness or other possible reasons tend to support stock prices in the fourth quarter. Given the poor levels of investor sentiment and disdain for equities, the atmosphere is ripe for a Q4 rebound.

Finally, 2008 was such a difficult year for investors because the extent of the problems associated with the sub-prime meltdown and the derivative damage were open-ended. No one really knew how deep the problems went because of the interconnectedness and poor transparency that surrounded the counterparties of sub-prime related credit default swaps/obligations. Exacerbated by leverage, sold, repackaged, and resold, the problems were duplicated many times over and it was difficult to decipher who would succumb to the implosion. The stock market hates uncertainty, and in 2008, no one was certain how deep the damage could be. With titans of Wall Street disappearing overnight, it was a legitimate concern to wonder if the financial system as a whole was at risk.

The problems in Europe, however, are well documented. The amount of sovereign debt and its locations are also known. The countries in Europe with large budget-deficit problems are also well publicized. While this information will not prevent the damage, it certainly stands in contrast to the open-ended uncertainty that characterized 2008. The volatility in Europe stems from its attempt to resolve the situation amid cultural differences between members and an intricate political structure of the European Union and ECB. The discussion on how to contain the sovereign debt crisis torments the market, which would prefer a decisive solution administered by a powerful and determined financial authority. While stringing the situation along is painful in the near-term, it may actually allow other struggling countries in Europe time to right their budget problems and enact measured reform before bailout funds are required to force them to act. Regardless, an end to the debate will come and financial markets will recover. We intend to benefit from it.

Best regards,



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