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## Making Sense of It All

After a brutal week in global equity markets (the S&P 500 Index fell 7.2% on the week, and is down 11.3% since July 7<sup>th</sup>), the decision by Standard & Poor's to downgrade U.S. Treasury debt has added yet another layer of fear and uncertainty to an already volatile market. In the weeks ahead, markets will be monitoring efforts by European policymakers to deal with their debt crisis, new data on the pace of the U.S. economy and any potential efforts by the Federal Reserve to support the economy and markets here at home. In the midst of all this, a strong earnings season and a steep selloff in stocks, coupled with a rally in bonds, have left relative valuations at extreme levels.

In theory, policy makers have the tools to stabilize financial markets; economies have the potential to grow; and relative market valuations have the potential to move towards normal. However, a key question for investors is whether fears emanating from volatile financial markets can become self-fulfilling, and derail the gradual recovery in both the economy and markets.

In the following paragraphs, we'll briefly look at three pressing issues:

- Making sense of S&P's downgrade of U.S. Treasuries
- The pace of recovery in the U.S.
- The ongoing debt situation in Europe

### **Making sense of the downgrade: It's all fun and games until somebody loses an "A"**

#### **What happened?**

On Friday, Standard & Poor's downgraded the U.S. long-term sovereign debt rating one notch, from "AAA" to "AA+". It is worth noting that S&P affirmed the U.S. short-term debt rating of A-1+, and removed both short and long-term ratings from CreditWatch negative, as passage of the Budget Control Act (BAC) eliminated any immediate threat of default by raising the debt limit. Despite the actions taken by Standard & Poor's, the nation's other major rating agencies (Moody's and Fitch) reaffirmed the U.S. AAA rating, but remained on negative watch.

**Table 1: Credit Ratings of Select Sovereigns**

Based on S&P ratings

AAA	AA+	AA	AA-	A+	A	BBB+	BB	BBB-
Canada	Belgium	Chile	China	Italy	Mexico	Ireland	Bulgaria	Croatia
U.K.	U.S.	Spain	Japan	Korea	Poland	Russia	Bahrain	India
Germany	New Zealand	Abu Dhabi	Israel	Slovak Republic	South Africa	Brazil	Morocco	Barbados
France		Kuwait	Saudi Arabia	Czech Republic	Estonia	Peru	Lithuania	Iceland

**S&P definitions:**

**AAA**—Extremely strong capacity to meet financial commitments. Highest Rating

**AA**—Very strong capacity to meet financial commitments

**A**—Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances

**BBB**—Adequate capacity to meet financial commitments, but more subject to adverse economic conditions.

**BBB-**—Considered lowest investment grade by market participants

Sources: Standard & Poor's, J.P. Morgan Asset Management.  
Data are as of 8/7/11.

**Why did Standard & Poor's lower the rating?**

Credit ratings are, at their essence, opinions by ratings agencies as to the credit worthiness of borrowers. Generally, these ratings are based on an issuer's ability and willingness to meet its financial obligations - on time, and in full. It is in this context that rating agencies and other market observers have become concerned about the United States, as rapidly rising debt levels, over time, have the ability to undermine the U.S.'s long-run ability to meet these obligations. In the U.S., the debt-to-GDP ratio has risen from roughly 37% of GDP in 2006 to just shy of 66% of GDP today, and most forecasts show a continued rise<sup>1</sup>.

As we've written previously, any solution to U.S. debt problems will require a disciplined plan to both cut entitlement spending and raise taxes over a number of years. This view was at the root of Standard & Poor's decision; *"It appears that for now, new revenues have dropped down in the menu of policy options. In addition, the plan (The Budget Control Act) envisions only minor policy changes on Medicare and little change in other entitlements, the containment of which we and most other independent observers regard as key to long-term fiscal sustainability."*

Of particular importance (and concern) is the extent to which S&P emphasized the role of politics in its judgment of the U.S. fiscal outlook; *"Our lowering of the rating was prompted by our view on the rising public debt burden and our perception of greater policymaking uncertainty... Our opinion is that elected officials remain wary of tackling the structural issues required to effectively address the rising U.S. public debt burden in a manner consistent with a 'AAA' rating..."*. What's more, recent comments to the press by Standard & Poor's officials suggest further downgrades could be on the horizon if progress isn't made on these fronts.

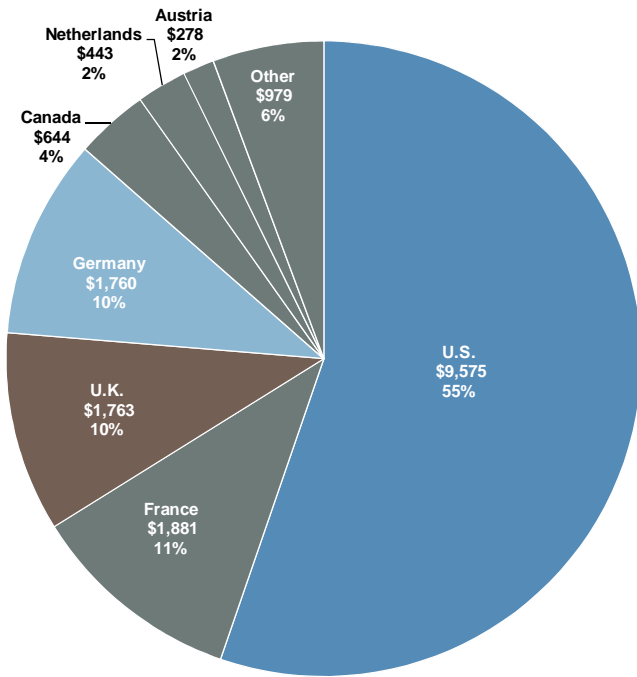
<sup>1</sup> Congressional Budget Office, An Analysis of the President's Budgetary Proposals for Fiscal Year 2012 (April 2011)

**What does this mean for markets?**

While it is impossible to predict how markets will react this week and longer-term, it is indeed possible that some of this has already been priced into equity markets. However, as the time of this writing, foreign markets have opened lower and U.S. equity futures appear to be under pressure, signaling a continued – and possibly emotionally driven – aversion to risk<sup>2</sup>.

Bond markets, on the other hand, are less likely to see major disruptions. As the chart below indicates, prior to this downgrade, the U.S. accounted for more than half of the world’s total AAA-rated sovereign debt, suggesting a shortage of “places to go” for investors who might be prompted to sell U.S. debt due to the downgrade. Furthermore, many large creditors to the U.S. expressed their confidence in the U.S., although some – like China - took the opportunity to press the U.S. to take even further steps towards fiscal stability.

**Chart 1: AAA Rated Sovereign Debt Outstanding**  
Prior to downgrade, % of total



Sources: Standard & Poor’s, Bloomberg, J.P. Morgan Asset Management. Other includes Australia, Denmark, Sweden, Switzerland, Finland, Hong Kong, Norway and New Zealand. Data are as of 8/4/11.

<sup>2</sup> Based on Bloomberg and FactSet data.

**A Look at the U.S. Economy**

Uncertainty related to the U.S. economic outlook also contributed to the market’s sell-off. Lackluster economic growth has been a persistent theme over the course of the current recovery, a fact reinforced at the end of July when the BEA released their annual revisions to GDP, which showed a deeper recession than originally thought (cumulative real GDP loss of 4.1% revised to 5.1%), and a slower recovery with potentially waning momentum.

**2011 – The First Half**

It is also important to recognize that the global economy suffered several shocks to begin the year – most notably a surge in commodity prices that, via higher gas prices, took a bite out of consumer spending and confidence. In March, Japan suffered a devastating earthquake and tsunami, the effects of which were felt the world over and on display in global supply chain disruptions. This resulted in slower industrial activity and weaker overall economic output. Finally, as suggested in the Fed’s “Beige Book”, extreme weather events in the first half of the year also hampered regional economic activity. Through all of this, corporate profits have proven to be extremely resilient, with S&P 500 operating earnings eclipsing an all-time record high in the second quarter of this year.

**2011 – The Year Ahead**

The expectation throughout this year has been that these headwinds will slowly lift in the second half of the year, allowing auto production and overall consumption to normalize. Export growth on the back of a weaker dollar, combined with any marginal rebound in home building, could also help later this year. Even as these shocks fade, growth will still face the fiscal drag caused by less government spending (which should decrease future growth).

Putting this all together leaves investors particularly uncertain about the economic outlook, and therein lies the real danger: If consumers freeze-up and decide to “wait and see” in the face of so many cross-currents, declining growth could become a self fulfilling prophecy, increasing the odds of a recession, despite underlying momentum and pent-up demand.

### The Ongoing Troubles in Europe

Finally, fear and uncertainty emanating from Europe's debt crisis have hurt confidence and rattled markets. While the issues in Europe are very complex, the primary threat is eerily similar to the financial crisis we saw in the U.S. in 2008-2009.

Because governments, businesses and consumers alike all rely upon credit to make investments (new plant and equipment, building infrastructure or buying a new home), credit can be viewed as the grease that keeps the economic wheels turning.

At the heart of credit markets is the bank-to-bank lending market, where banks lend money – usually at very low interest rates – to each other. During the financial crisis, as banks became wary over one another's exposure to so-called "toxic assets" (in this instance, mortgage-backed assets), bank-to-bank lending ground to a halt, causing a global contagion that left the economic gears grinding to a halt. Only after meeting the crisis with "overwhelming force" was the Fed able to get the economy on the track back towards normal.

In Europe, the "toxic assets" are sovereign debt, to which many banks have large exposure. As high debt burdens have led to fears that countries may default on their debts, bank assets have been called into question, threatening credit markets globally.

Today, we are watching developments in Europe closely, and monitoring the decisions of both governments and the ECB in responding to the ongoing crisis. We will also continue to monitor Libor spreads, which remain below their 2010 peak levels, for evidence of stress in credit markets. We believe that policymakers have the tools in the near-term to deal with liquidity issues, but political discipline will be needed to implement the fiscal tightening required to solve the problems going forward.

### Parting thoughts

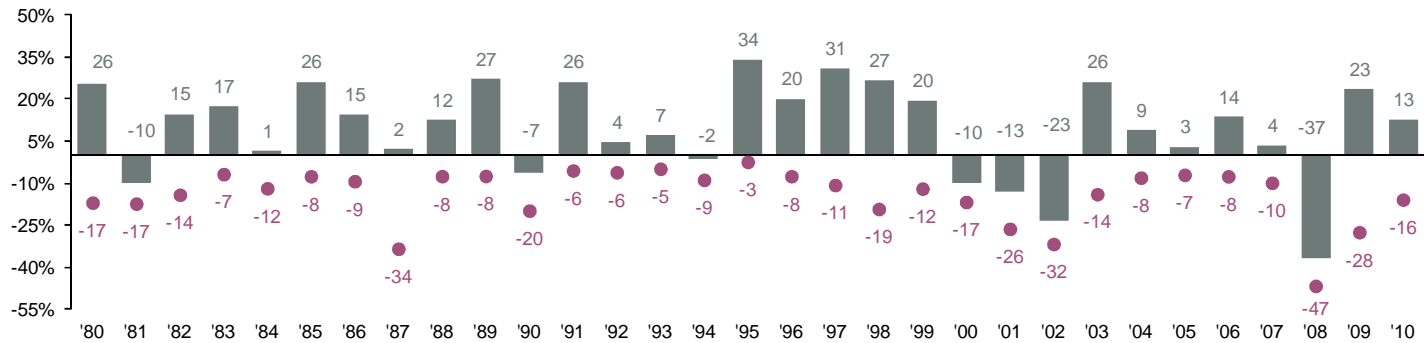
As we consider these three issues in aggregate (S&P downgrade, weak U.S. growth, and lack of clarity from Europe), it is understandable that markets have been so volatile. Indeed, investors today find themselves yet again in seemingly uncharted waters, seeking answers in a world that has grown increasingly complicated.

At the same time, we also take solace in how far we have come in understanding the problems. In 2008-2009, most market participants were ignorant to the serious problems of an over-levered economy. Today, corporate balance sheets are lean and healthy, household balance sheets are rapidly improving and governments are keenly aware of the need to rein in debt. While this process can be ugly, as evidenced by the debt ceiling debate, it is important that investors recognize that the very fact that the debates are happening is a step in the right direction.

Given a choice between the polar outcomes of long-term success in finding solutions to these problems or catastrophic failure, we are inclined to pick the former over the latter. If we're right, we continue to believe that a well-diversified approach to investing is the best strategy for long-term investors.

Below is a chart from page 58 from our Guide to the Markets, showing historical calendar year returns (grey bars), and intra-year market declines or corrections (red dots). While by no means a guarantee of future results, it is important to recognize that volatility is normal. Despite an average intra-year drop or correction of 14.3% since 1980, markets have finished in positive territory in 24 of 31 years. Last year, the S&P 500 Index returned 13% (15.1% including dividends), despite declining 16% from April 23<sup>rd</sup> to July 5<sup>th</sup>.

**Chart 2: Intra-year Declines vs. Calendar Year Returns**



Sources: Standard & Poor's, FactSet, J.P. Morgan Asset Management.  
Returns based on price only and do not include dividends. For illustrative purposes only.  
Data are as of 8/7/11.

While we appreciate the severity of the issues now dominating the financial environment, we also note that current very low bond yields and relatively low P/E ratios on stocks suggest that markets are already, to a very large extent, discounting a weak and uncertain economic environment. Given this, it is important that investors maintain a balanced perspective on the current environment. We believe that such an unbiased perspective still suggests the need for a balanced approach to risk-taking with appropriate exposure to all asset classes.

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