

## **What has caused the recent panic in the financial markets?**

The recent volatility in the markets is likely caused by deterioration in a couple of key areas: lower global economic growth; European sovereign credit problems; and various U.S. political issues including the debt ceiling debate and the S&P credit downgrade.

Growth expectations for the U.S. economy have decreased from roughly 3 - 3.5% (projected four months ago) to a current annualized rate of approximately 1.5 - 2.0%. The slowing of U.S. growth coincides with a pause in international growth due a combination of sovereign debt problems in Europe, production bottlenecks in Japan after the earthquake, and a modest deceleration in Chinese growth.

While not surprising, the inability of our political leaders to reach a meaningful agreement on the debt ceiling complicates the economic outlook. Global investors watching the political process are forced to question the likely future progress on the following structural issues facing the U.S. government:

- Pension Reform
- Social Security / Medicare / Medicaid
- Health Care

It's probable that the S&P downgrade combined with public frustration with the political process helped trigger the timing of the recent equity market meltdown.

The recent extreme volatility is correlated to the heavy institutional ownership of stocks, and the short-term performance orientation of these portfolio managers. The herd mentality of these professional investors has translated into downward price adjustments that seemed to far outweigh the changes in business prospects.

## **Is the recent financial market pessimism signaling an inevitable economic recession?**

While the recent loss of confidence is troubling, it does not translate into an inevitable economic downturn. The U.S. manufacturing base is performing well. Cash flow and earnings remain strong. Consumer and business reports indicate substantial debt paydowns and improving corporate and individual balance sheets.

The most likely scenario is that the U.S. economy will resume growth at a 1.5% to 2.0% pace in the second half of 2011. Over the coming months, chances seem higher for positive surprises regarding growth rather than negative surprises.

## **How troubling is the lack of job growth in the United States?**

The current lack of employment growth is part of a longer-term trend. U.S. businesses painfully adjusted their employment levels during the economic downturn and have been reluctant to increase payroll expenses. It will take a significant boost in demand for many businesses to step up their hiring.

The Federal Reserve has reacted to the weakness in employment growth by maintaining an accommodative monetary policy. Policymakers will likely maintain policy tilted towards ease for an extended period to prevent an economic downturn.

## **What risk is likely under appreciated by investors?**

The biggest risk not fully discounted in current market prices is rising inflation. The upward trend in commodity prices, especially food and energy costs, are difficult to manage. In addition, the increasing wage pressures in the emerging market economies indicate the start of global wage inflation that will eventually be felt in the United States. The lack of quality applicants for many positions in the U.S. is a warning sign of trouble on the horizon in this area.

## **How should investors react to the recent downturn in the equity market?**

The recent roller coaster ride in the equity market challenges investors to really understand their risk tolerances. If the volatility is too great for their financial position or emotional comfort, investors need to build a plan to adjust the risk.

Getting the right mix of equities, bonds and cash is critical to long-term success of investing. Investors that use this experience to review their holdings will be better prepared to withstand the challenges that inevitably lie ahead in this turbulent market.