

# Walden Capital Newsletter

Walden Capital Advisors

Second Quarter 2011

## Quarterly Investment Commentary

While the stock market had a good first half of 2011, the second quarter was relatively flat. A number of issues have been weighing on the markets.

A Greek default is a concern, particularly the risk of contagion spreading to the other weak EU countries and the broader financial system.

There are increasing concerns over whether China can engineer a "soft landing" for its economy.

At home, the debt/deficit problem is significant and needs to be addressed.

U.S. companies have had strong earnings so far this year, profit margins are high and balance sheets are stronger.

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The momentum that carried stocks higher through the first four months of the year fizzled in May as investors became increasingly concerned about a slowing economy (exacerbated by supply chain interruptions stemming from the Japan earthquake) and fears that a Greek default would spread contagion to other weak EU members and rattle the European and even global financial systems. Those concerns, particularly relating to Greece, intensified as the second quarter progressed, and a modest retreat in May worsened in June before we saw a late-month rebound as it became increasingly likely that the EU and IMF would manage to kick Greece's debt can down the road at least one more time.

When the dust settled, stocks wound up roughly flat for the quarter. Large-cap U.S. stocks were barely positive while mid-caps were up only 0.4% and smaller-cap stocks lost 1.6%. Growth did better than value. Domestic high-quality, intermediate-term bonds gained 2.2% for the quarter. Looking abroad, developed-market foreign stocks gained 1.6%, while emerging-markets equities fell 1.2%. Local-currency emerging-markets bonds had a strong quarter, gaining 4%. For the first six months, U.S. equities lead international stocks with the S & P 500 up 6% compared to MSCI EAFE which was up 5% and MSCI Emerging Markets which was up only 0.9%. The Barclays US Aggregate Bond Index was up 2.7% year to date.

## Quick Take

There are a handful of issues which are causing uncertainty in the investment landscape. We have provided a brief summary here first and more detail in subsequent sections.

There continue to be potential risks out there that could affect the investment markets. The possibility of a Greek default is in the headlines, but there are other risks as well including the chance that China sees a sharp slowdown that affects the global economy, our own debt problems (both at the household and government level), and the slow pace of economic recovery due to persistent weakness in jobs and housing. Left unresolved, these issues create uncertainty and suggest that it will be harder for the economy to grow at a normal pace in the years ahead. It is difficult to predict how these global and domestic issues will unfold in the years ahead because they are complex.

In terms of setting expectations, markets could continue to climb in the short term. Very low interest rates encourage investors to take risk and, as time passes, can contribute to complacency. But time won't fix the problems such as our federal deficit or Greece's unsustainable debt load. These problems will either come to a head on their own, or actions will be taken to fix the problems—either course will likely result in some pain. As we have stated numerous times in the past, predicting the short term is not something we believe anyone can do reliably and consistently. We therefore make our primary investment decisions based on analysis of longer-term factors, which we can do with much higher confidence, while considering shorter-term opportunities that may present themselves along the way.

### **Greek Debt Crisis Fears (Again)**

It appears that the European Union, the European Central Bank, and the International Monetary Fund will once again provide Greece with additional financial assistance (i.e., loans at below-market interest rates) in return for Greek promises of more fiscal austerity. The aim is to buy more time with the hope that Greece will ultimately be able to get its fiscal house in order and pay back the debt. However, it is likely that some type of Greek default or “restructuring” or “reprofiling” — in which the debt repayment schedule is extended but the principal value is not marked down—is inevitable given the severity of their situation. As one investment strategist put it, “Everyone knows Greece will default—it's just a question of whether it's orderly or disorderly.”

By itself, a Greek default is probably manageable for the global financial system without causing a crisis. However, the bigger concern is that a Greek default could spiral into a broader European debt “contagion” spreading to other heavily indebted European countries, such as Ireland and Portugal and possibly even Spain or Italy. Even if these

other countries don't want to default, they could be forced into it that situation if the market refuses to lend to them and they then can't roll over their debt. The hope is that the central banks and the IMF can come up with enough financial support to restore confidence before the financial system is overwhelmed.

Greece remains a rapidly evolving situation. Should there be a crisis in the near term related to Greek debt, we'd expect Treasury yields to fall/prices to rise and “risk assets” such as stocks and emerging-market currencies to fall. Treasury bonds are still perceived as a “safe haven” asset class — despite the U.S.'s own debt problems.

### **China Hard Landing**

Another potential risk is a “hard landing” for the Chinese economy (as opposed to a smooth manageable slowdown) and the global ripple effects that would result. Most experts agree that there is a bubble in at least some segments of China's property market. The general consensus is that this bubble is not widespread and can be managed by the Chinese government, as it has been in the past. There is a risk, however, that the bubble may have already grown very big and, if pricked, will result in a sharp contraction for China, which would most likely be negative for equities, commodities, and emerging-markets local-currency bonds. It is hard to really know whether the optimists or pessimists are right, partly because of the lack of reliable information from China.

For much of the last two decades, China has been building infrastructure — residential and commercial real estate, factories, roads, bridges, etc. — that may have made sense for the urbanization rate it experienced then. In large part, this urbanization was driven by much of the developed world spending beyond its means, enabled by excessive borrowing. So, the question is: has China factored the ongoing developed-market deleveraging into its infrastructure plans? This

does not seem to be the case. In fact, fixed-investment spending has grown at a faster rate in the past two years than it did before the crisis. It is difficult to imagine that all the excess capacity that has likely resulted from this above-normal investment, at a time when the developed world is deleveraging (and must continue to deleverage), can be soaked up by China's domestic consumption. China has a \$1.5 trillion consumer economy versus \$20 trillion for United States and Europe combined. Further, China is inducing a negative wealth effect among the rich urban Chinese by pricking the housing bubble there—and rural China does not have high enough per-capita incomes to absorb all the excess industrial capacity China likely now has.

### **The U.S. Economy Is Slowing Again**

Recent U.S. economic news has been disappointing, with sluggish GDP growth and continued weakness in employment and housing (which are important drivers of consumer confidence, income, and spending.) On the jobs front, the latest employment report for May showed growth in nonfarm payrolls of only 54,000 for the month, a big drop from the 220,000 monthly average increase in the prior three months. We have seen estimates (from various economists) that the economy must create anywhere between 100,000 and 200,000 net, new jobs each month just to absorb the natural flow of new entrants into the labor force and keep the unemployment rate flat. The unemployment rate in May ticked up to 9.1%. Meanwhile, private and government economists have been cutting their growth forecasts for the year to below 2.5%–3% in most cases.

### **Reasons to be Optimistic**

Corporate earnings so far in 2011 have been good. Profit margins are high, balance sheets are strong and companies are sitting on record levels of cash. We would expect higher

returns on equities if corporate earnings growth materially improves while stock prices remain flat. There is also a positive impact on earnings-growth estimates from the growing share of U.S. corporate profits coming from emerging-markets demand. Credible and concrete policy actions to control the United States' long-term structural budget deficit and evidence of successful deleveraging among the public and private sectors would be additional fundamental factors that could lead to greater optimism. Finally, if the economy continues to slow, it is likely that the Federal Reserve and the government would implement additional stimulative measures so it is hard to be negative on equities when the alternatives are low yielding bonds and cash.

### **A Concluding Reminder**

As we've written in our past commentaries, if there is one thing we can be almost certain of, it is that there will be market ups and downs over the next few years. We remind you once again how important it is that you have the appropriate asset allocation for your goals, time horizon and level of risk tolerance so that you are able to withstand the inevitable short-term volatility in return for the prospect of longer-term growth.

*Please contact Walden Capital Advisors promptly if there are any changes in your financial situation or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to the management of your account.*

*Our current disclosure statement is set forth on Form ADV Part 2 and is available for your review upon request.*