MARKET NOTES

WILMINGTON TRUST

July 16, 2010

Rex Macey, CFA®, CIMA, CFP®, Chief Investment Officer
Wilmington Trust Investment Management

More on—and Less in—Debt

Key points:

- This was (or is) not just a deep recession. This is a deleveraging cycle.
- The "wall of debt" coming due does not overly worry us.
- Assuming the United States does not fall into a new recession, equity valuations appear attractive.

Investors continue to vacillate over the economy's near-term prospects. The stock market tumbled in the latter half of June, as investors worried about a double-dip recession. The first half of this month saw the stock market strengthen, suggesting greater confidence in economic growth, albeit at a low rate. Today stocks tumbled on news that consumer confidence has slumped. Our view and our model portfolios have exhibited greater equanimity than the market. Throughout the year we have forecast weak economic growth and have positioned the portfolios accordingly—such as with unusually high levels of speculative-grade, or high-yield, corporate bonds. We've recommended focusing within the speculative-grade universe on the highest-rated bonds. At this juncture we see no reason to change our outlook or our investment recommendations.

Testing Europe's banks

Looking ahead, the July 23 release of the results of stress tests on 91 European banks may lead to further market gyrations. If the European banking system looks strong, we would expect to see the U.S. dollar and U.S. Treasury bonds fall, U.S. large caps (exporters) to do better than small caps, and stocks in developed international equity markets to do well. If the results are bad enough, and we have no reason to expect the worst, investors could fear another financial crisis. The tests themselves must be credible, which relates to their difficulty and transparency.

Deleveraging, largely by defaulting

We were in a recession, and since the National Bureau of Economic Research has not proclaimed its end, we may still be in one. But as our friends at Bridgewater Associates would point out, this is not just a recession—it is also a period of significant household deleveraging. If this were just a recession, we would expect a much greater increase in economic activity in response to the Fed's easy monetary policy. In a period of deleveraging, many would-be lenders are unable or unwilling to lend and many would-be borrowers are unable or unwilling to borrow regardless of low interest rates. In the current deleveraging cycle, U.S. households have defaulted on $950 billion of debt—almost three times as much as the $318 billion worth of debt they have paid off—and household debt levels have fallen from 124% to 111% of income (source: Bridgewater). The financial obligations ratio, which measures debt, including auto lease payments and rents, as a share of disposable personal income, has fallen from almost 19% to 17%, according to the Fed. Yet as households (and corporations) have been cutting their debt levels, governments at the local, state, and federal levels have been adding to their own. The net effect, in terms of all debt owed by U.S. citizens, corporations, and governments, has been a 1.9% reduction from the peak level of total indebtedness, according to the Fed. As of March 31, those entities combined to owe just under $50 trillion to creditors ($49.98 trillion), down from $50.95 trillion at the peak one year earlier.

The wall of debt

We've seen several articles suggesting a maturing "wall of debt" could overwhelm the fragile economic recovery. We're in the camp that believes this massive rollover of debt is unlikely to be a problem. For every borrower (bond issuer), there is a lender (investor). The wall of debt that is coming due is held by lenders. Generally, when these bondholders receive principal payments they will reinvest the proceeds. As long as the lenders want to continue to lend money—and if they didn't they probably would have already sold their bonds—they will effectively swap their old, maturing debt for newly issued debt. In practice, we recognize that issuers may be shifting the maturities of their debts.

One major issue is whether the interest payments on new debt are going to be higher or lower than they were on the old debt. Declining interest rates mean that borrowers' interest payments will go down as bonds mature and new ones are issued, helping issuers and hurting investors. However, from a broad economic perspective, a change in rates just shifts cash flows among market participants. The second question is whether lenders will be willing to refinance. We believe they will. If they were unwilling, interest rates would be going up. Of course, higher rates may yet materialize. In any event, investors will have to do something with the cash from maturing bonds. We do not believe they are likely to dump their assets ***en masse*** into stocks or money markets that offer virtually no yield.

Wobbly economic data driving volatility

The stock market has been choppy this year: Consider, for example, that the closing price of the S&P 500® Index has crossed 1080 fifteen times. The stock market has a price-to-earnings (P/E) ratio of 13.3 based on estimated 2010 earnings and 11.3 based on those for 2011. Presumably these multiples would rise if fears of a "double dip" give way to confidence in a continuing economic recovery. Given the uncertainty about worldwide growth, earnings estimates contain more than the usual dose of uncertainty, especially looking into 2011. If we experience a double dip, the E (earnings) of the P/E would fall, and equity markets almost certainly would tumble. Absent a double-dip scenario, valuations look attractive, especially in light of the low interest rate environment that the Fed appears ready to support for the foreseeable future. The second-quarter earnings reporting season is underway. It appears that, similar to last quarter, about three-quarters of public companies are beating Wall Street's estimates of their earnings and two-thirds are ahead of revenue forecasts. However, financial companies are looking light on the revenue side and this may weigh on the market. The volatility of the stock market has been driven by wobbly economic data. Given the continued elevated volatility we expect from stocks, we remain cautious on our equity allocations. We expect a recovery without a double dip, but there will be bumps along the way.

determination by Wilmington Trust that any investment strategy is suitable for a specific investor. Investors should seek financial advice regarding the suitability of any investment strategy based on the investor's objectives, financial situation, and particular needs. Diversification does not ensure a profit or guarantee against a loss. There is no assurance that any investment strategy will be successful. Past performance is no guarantee of future results.

Any investment products discussed in this publication are not insured by the FDIC or any other governmental agency, are not deposits of or other obligations of or guaranteed by Wilmington Trust or any other bank or entity, and are subject to risks, including a possible loss of the principal amount invested. Some investment products may be available only to certain "qualified investors"—that is, investors who meet certain income and/or investable assets thresholds. Investing involves risk and you may incur a profit or a loss.

CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute. Other third-party marks and brands are the property of their respective owners.

Follow us on Twitter.

Connect with us on Facebook.