

## Thought for the Week: Monday, August 8<sup>th</sup>, 2011

### Market Update

What a weekend! Most of it was spent huddled in conference discussing the impact of the U.S. Government debt downgrade by Standard & Pooors. Further to which, here are our current thoughts.

#### What is Happening?

The US downgrade superficially raises two main concerns. The first is the impact on interest rates – would the downgrade increase the cost of borrowing for the U.S., thereby worsening the deficit and debt issues. The second is the collateral effect, particularly through funding markets of the loss of AAA collateral. Both appear to have been dismissed by the market – for evidence look at today’s U.S. Treasury falling yields.

What is really happening is the market is panicking about U.S. and Global growth prospects. As the conclusion to last week’s parable stated, the only way out of the debt crisis is economic growth. With it, the current issues will disappear. Without growth, things will be tough.

All recent data suggests growth slowing. Normally, an economy will chug along at a nice sustainable growth rate – often between 3% and 5%. Any higher and we worry about overheating. Any lower and we worry about the economy stalling. The U.S. economy grew 1% in the first half of 2011 – if it doesn’t pick up soon, it may stall.

At the same time, Emerging Markets, which have fuelled much of the recent economic growth, are slowing from their exceptionally high “close to overheating” levels.

These dire economic growth forecasts are discounting stock prices and virtually all other assets, except Treasuries.

#### Effects on other countries of previous rating cuts



Photos, left to right: Zuma Press, Associated Press, European Pressphoto Agency, Getty Images Source: Market Data Group (downgrade charts); Standard & Pooors (ratings)

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## What are we doing about the Market Turmoil?

Since our April 25<sup>th</sup>, 2011 Thought for the Week we have positioned our portfolios more defensively than normal. This means we have held more cash and reduced the Beta (the amount a security may move related to broad market movement). A High Beta security will normally move more than the market and a low beta security will move less than the overall market. As a result, our conservative portfolio is now down approximately 1% for the year.

Our defensive positioning includes the use of Senior Loans which commonly pay a floating rate of income and therefore do not have the same volatility as other income vehicles.

On the negative side, we hedged the potential for a U.S. downgrade by using TBT's – a security which shorts the 20-year Treasury. Unfortunately, the downgrade actually caused the 20-year to rise in value. We protected the portfolios but paid a price for doing so.

We are protecting the downside in an attempt to lose less than the market while keeping some cash and liquidity to take advantage of opportunities.

Avoiding the temptation to overhaul a portfolio in response to day-to-day news is the mark of a successful investor. In our view, it's best not to make dramatic changes on days when we have high volatility.

## Potential Opportunities

As prices have fallen, income levels have risen proportionally. Just like 2008, as the decline moderates, usually the point of maximum despair, we will be ready at the front of the line to snap up quality securities that we feel will reward portfolios with attractive income.

Income markets generally reward one simple rule: price weakness is usually a buying signal as the yields become more and more attractive. At this time, with many corporate balance sheets in pristine condition and the chance of default over the next three to five years virtually non-existent, we are increasingly excited by the opportunities.

Markets such as this are exceptionally tough for investors on a daily basis – we certainly understand the fear and frustration associated with following the short-term price and sentiment moves. But this is not a sell signal. Although we do not suggest that markets have found a bottom, we certainly feel this is a good entry point for many asset classes using the cash we have on the sidelines. For example:

- We exited Preferred Stock late 2010 fearing a devaluation. The Preferred asset class once again represents excellent value with 8% to 9% yields. We expect to take increasing advantage of these discounted yields in the same way as 2008.
- Master Limited Partnerships (MLPs): The yields on some of these securities have spiked to 8%-plus. We are currently looking at adding a number of funds which contain MLPs as a way to participate without the tax implications of owning directly.
- Corporate Bonds: As described in recent Thoughts, Corporate spreads have widened again and we should be able to take advantage of this spread. Many large corporations are the new AAA rated paper, in the opinion of our balance sheet directed research and analysis. With corporate margins and cash levels at record highs, we feel this is an attractive opportunity.

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Taking out the sentiment of the S&P downgrade and European pressures, we still feel the U.S. economy is on for a slow but steady recovery. This is a call out to the U.S. Government to say things have gone too far and it's time to really stimulate the economy.

## Income

For most investors, the need for income is their primary investment goal. Just like buying a bond, for these clients, market valuation should be secondary to the continued payment of the coupon. Our conservative portfolios have not only maintained a 5.5% plus level of income, but now have the opportunity to pick up higher yielding investments. This should be a major consideration in the decision to stay invested. To sell income producing investments now would be following the panicking herd.

While falling stock prices are a nightmare for investors that focus on growth, for the income investor who concentrates on yield, falling valuations represent an opportunity to lock in high yields.

We have not made large scale moves to cash and similar "no or low" yield investments as we feel the current issues are temporary. As markets have dropped, we can now go shopping for discounted income producing securities which should step up the yield to investors and provide a quicker spring back in valuations, when markets recover.

Focusing on income should allow investors to ride these periodic corrections and downturns in market sentiment.

## Is this another 2008? Is this time Really Different?

In our opinion, last week's U.S. credit downgrade has not changed our comments of recent weeks. S&P telegraphed their move and the opening strength of U.S. Treasuries this morning supports this view.

Is there such a thing as AAA debt anymore? Is AA is the new AAA? Are cash rich corporations the new AAA?

Since the Credit/Liquidity Crisis of 2008 where money stopped circulating, companies and the consumer have aggressively deleveraged; they have led the way in living within their means. This is one of the reasons why companies are not adding jobs as quickly as the economy would like, because they are stockpiling cash. It is now the turn of the governments of the developed world, principally America and Europe, to deleverage. Unlike 2008, countries don't go out of business. Yes, they can default on their debt but this normally happens in a structured manner in First World countries.

What happened in 2008, and the first part of 2009, was the forced sale of equities and other securities, to generate cash. The credit system stopped working so institutions, banks, etc. had to raise cash to continue operations.

We don't think this is another 2008, credit is working well and companies are producing record earnings.

In the U.S. it is political. S&P said on Friday that it was downgrading U.S. debt for the first time in history because it lacks confidence that political leaders will make the choices needed to avert a long-term fiscal crisis.

As Warren Buffett once remarked, "*Be fearful when others are greedy and greedy when others are fearful.*"

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## How long will this Last?

This is the \$64,000 question and one no one really knows. We definitely need economic data which contradicts the “double-dip” recessionary views. Markets have dismissed strong corporate earnings on the basis that the excellent numbers cannot continue if the economy goes back into recession. We feel this is inaccurate as corporate growth is primarily coming from emerging markets, not the U.S. That said, we have removed all exposure to cyclical companies that will be affected by U.S. recessionary forces.

Both U.S. and European Governments need to act decisively. Part of the current crisis has been caused by “Hedge Fund-type” investors betting against various governments and their commitment to stick with their policies. For example, the Euro crisis is a revolving door of investors shorting the debt of a country and the ECB trying to do as little as possible to bail the country out.

Although the ECB now appear to be moving in a more focused manner, our own political system appears to block swift and decisive actions aimed at righting the financial ship.

Maybe Ben Bernanke will pull a rabbit out of his hat at the Fed meeting on Tuesday?

## Is the Worst Over or Just Beginning?

Although we remain confident in the long term prospects for our portfolios, the timing of a bounce back in equity markets is in the hands of the politicians and government officials. Today, Monday, the President’s address exacerbated the situation. Tomorrow, Tuesday, the Fed meets and markets will wait for encouraging statements or actions.

These are volatile, fast moving times and it would be inappropriate to make any comments on the timing of a recovery until after the Fed meeting. We will scrutinize every word looking for clues.

## Final Word on Portfolios

Although we have hedged much of our exposure, the portfolios have remained invested to allow us to take advantage of the opportunities as they arise. Markets definitely fell further than we expected and Treasuries appreciated more than we thought. We do not try to time markets; therefore, this has resulted in more volatility than we would normally expect.

That said, many of our holdings are being priced as if there’s a liquidity crisis when there is no evidence to support this. Even Floating Rate notes were discounted as if there was a credit crisis when there’s little fundamental reason for them to move downwards.

This mispricing is an opportunity to load up the income truck. The corporate/treasury spreads will come back in and we will be the beneficiary. Senior Loans and Floaters will spring back quickly and this last week should slowly disappear in the rearview mirror.