

## *It's Not 2008*

### *Todd Veredus Intrinsic Value Team Interim Market Update*

The past two weeks have seen a sea change in investor perception as the markets are down almost 18% since July 21. We have been proven wrong in our thought that the market would remain in a trading range for the summer. The primary culprits here are 1) a new fear of recession, 2) a US debt downgrade by S&P, and; 3) concern about the stability of the European Union and its financial system. All of these have combined to take stocks down to near bear market territory. The question is, are we entering another 2008 type episode, and we do not think that is the case.

In our second quarter 2011 letter we shared a chart with you indicating concerns that if economic growth dips below 2%, a recession could follow. Immediately following that letter, we saw several items that began to weigh on the markets:

- GDP Growth was disappointing for the second quarter, and prior quarters were downgraded to well below 2%.
- The S&P put the US debt on watch for a downgrade, which occurred last Friday.
- A contentious process was pursued by Congress to raise the debt ceiling and reduce deficit spending.

The market is worried that the economy could slip into recession. This is despite the fact that we just experienced an excellent second quarter for S&P companies in both the revenues and earnings. Additionally, we are not seeing higher rates or signs of distress in the short term funding markets for US banks. European banks are experiencing some of these issues but not nearly the magnitude of what we saw in 2008. We do not think there is another Lehman type failure lurking.

You never know you are in a recession while it is occurring. We suspect that the economic results from late 2010 into mid 2011 may be revised into a mild recession (defined as two quarters of near zero or negative GDP growth). We will not know until sometime early next year whether the economic powers will make these revisions. If they do, it will be the first recession in modern history that occurred without the Fed raising rates aggressively. Higher commodity costs coupled with the Japanese disaster and lack of improvement in employment would probably be the reasons cited for any weakness. If this is the case, we are probably entering a mild recovery now as production ramps up in the second half of the year.

We think the market is more worried about this slowdown than is warranted. First, the commodity price spike seems to be subsiding, and lower gasoline prices are working their

way through the system which will help consumers. Also, the production shortfalls due to parts shortages from Japan are recovering. Japanese demand for many products is likely to be robust as rebuilding occurs. The emerging economies continue to grow and we continue to export manufactured products to them. The overextended portion of the US economy is the Government. Corporations are in excellent shape and the consumers finances are getting better. Government spending is what needs to be curtailed. Oddly, after taking the first step in this direction, Standard and Poors pursued a downgrade and investors sold stocks. S&P stressed their disappointment with the amount of budget cuts, completely ignoring that this is probably the first step in a long process. Government spending is being curtailed and will probably decline in a fairly orderly manner over the next 5 or more years.

Nobody knows how far the markets will take this downdraft. Our sense is that any economic slowdown is likely to be modest, and the economic impact of the credit rating downgrade should be minimal. A bear market is defined as a 20% decline from the recent top, and we are flirting with that level currently. Since any potential recession is likely to be limited, we believe most of the bad news is already reflected in the markets. Currently, we are watching consumer spending and industrial production numbers to see if the economy firms after the first half soft patch. We are also watching our trading partners to make sure the export markets remain robust. What would be most welcome would be some pro-growth measures from Washington. A foreign profits repatriation measure could bring cash back to the US for productive purposes and raise revenues at the same time. Tax reform to simplify the code and eliminate loopholes would also be helpful. Investment tax credits for capital spending would likely be well received. If the legislators are looking for things they can do to help, these would be some places to start.

We still think that the economic weakness investors worry about is largely behind us. We have seen many measures taken, including US deficit reduction and debt ceiling legislation, as well as measures from the European Central Bank to bolster their financial system. We think many of the problems are recognized and discounted in the marketplace. We will be making changes as this market permits to take advantage of opportunities that arise.

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8-9-11

S&P 500 close 8/8/11- 1119

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