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**Investment Thoughts: When in Rome...**

It is difficult to write anything about markets and political events today without being overtaken by rapid changes in headlines. As markets seem transfixed by the tumultuous sovereign debt crisis in Europe and ambient market volatility, it is hard to maintain a sense of balance when deciding a strategy for an investment portfolio. Part of the difficulty is that the outcome of our current condition seems more and more dependent on political judgments than economic ones. The politics of the Eurozone, where a common currency was created without first a political union, are now being laid bare. The inclination to drop weaker members, who abused their membership to run up large debts, creates a struggle to determine self-interests over the desire to hold the union together. Germany and France seek the support of their people to backstop the banking system's exposure to bad debt. Can there be transformation of these debts without destruction?

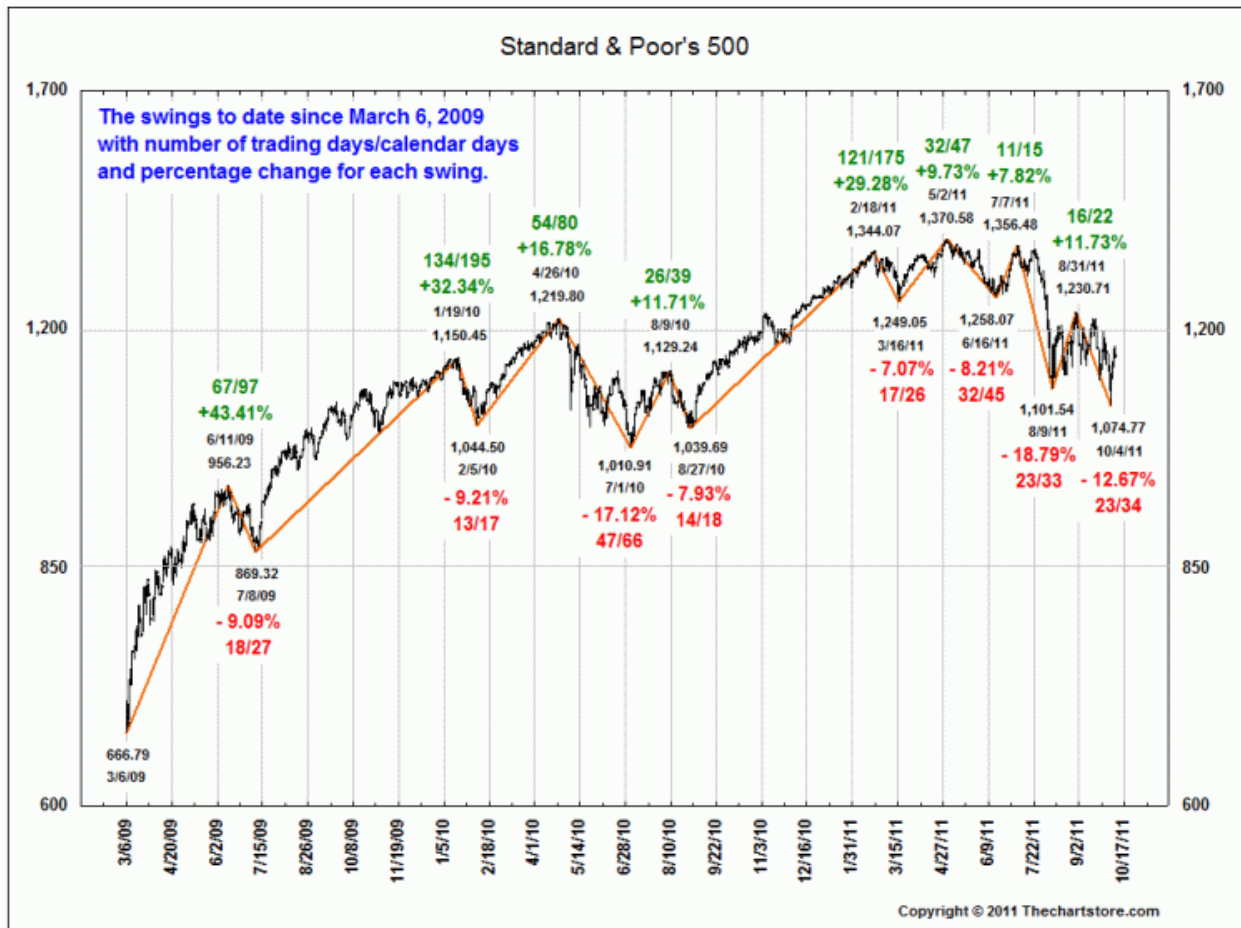
While revisiting Rome recently, I once again found myself behind police barriers observing the reaction of the man on the street to austerity measures proposed by a peripheral European country in financial trouble. In two particular cases, (one involving a labor union resisting wage cuts to save their jobs, the other, students protesting cuts to education), it was clear that the promises made by politicians to secure a bailout were not receiving endorsement on the street. The European social contract of job stability and retirement benefits is of necessity being rewritten, yet there is the echo of history and the rhythm of the culture in Europe that sets a different tempo to daily life that makes change slow to happen. I think the man on the street is not first and foremost a capitalist, but is now compelled to see financial reality.

The Greeks conceptualized the four elements - earth, wind, water and fire - to understand the physical world. European politicians must try to create a sort of financial fifth element, or quinta essentia, which will meet the very different needs of member countries. The answer seems to be that of finding a cost of servicing the debt within the means of each country. For example, Greece can have a high debt load if the cost of servicing it is low enough (see Japan that has a large debt load, but near zero interest costs).

A resolution to this sovereign debt crisis is absolutely critical for U.S. investors. If markets continue on edge, living day by day on the utterances of Angela Merkel and Nicholas Sarkozy, risk cannot be properly priced. That is, how can risks be priced into the creation of a new loan or the purchase of a stock or bond if one does not know whether the banking system is solid or not? I have noted in past *Investment Thoughts* that the preferred political choice to the sovereign debt issue will be to inflate it away over time rather than take the full fiscal restraint that would lead to a prolonged period of sub-par growth. It is still my view, but first today we fear most deflation and the current debt payments, but later we should be concerned with our purchasing power as governments allow currency debasement to shrink the debt pile.

In practical terms, a fix for the European debt crisis helps us avoid another 2008 style decline in global liquidity. Share prices in the U.S. have priced in a good deal of fear from sovereign default with the real earnings yield of the S&P 500 now approaching 6%. Corporate bond spreads, especially high yield, widened in response to Europe and now stand poised to contract, which is positive for bond prices. Third quarter corporate earnings will be coming out soon and will provide insight from management's outlook. Our preference is still defensive sectors over cyclical, though energy and technology shares seem attractive on valuation. Nevertheless, the most emphasis should be placed on income producing assets. We are working towards a 4% cash yield on portfolios to give us a minimum absolute return if markets don't appreciate.

The technical view of the market, however, must still be regarded as in a down trend wherein we are seeing some strong reversal days up and down 3-5%, which subsequently falter. We view the highly volatile, but largely sideways movement of the market since early August as part of a bottoming phase that may see a retest of a year ago levels near 1025-1050 for the S&P 500. A move above 1280, about 8% above today's level, would be very positive as this is the price of the 200 day moving average which was broken to the downside on August first this year. The following chart shows prices through 10/4/11. In our portfolios we have moved to the low end of the policy range for exposure to stocks and hold a defensive cash position of about 15% to protect client assets. The task will be to redeploy that cash in future at a time when risks can be better determined.



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