A Q&A About Our Market Confusion
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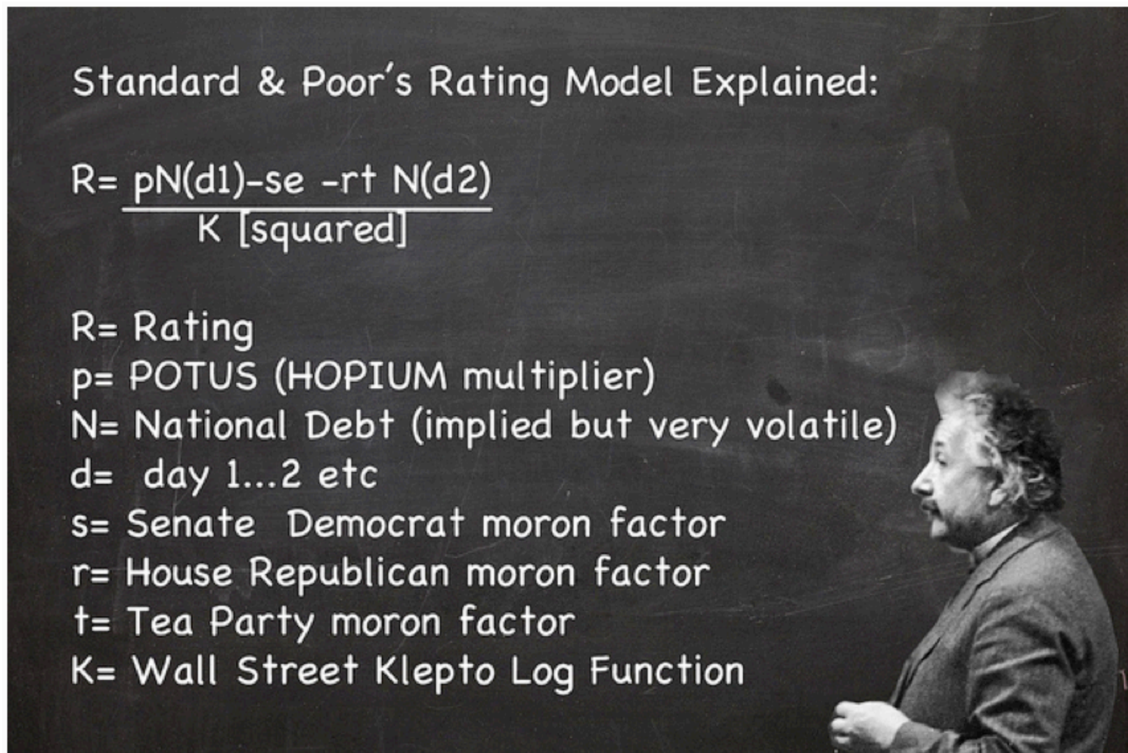
Here's an amusing graphic that sums up, perhaps in exaggerated form, how some people view the mathematics behind the recent



U.S. Treasury bond debt downgrade:

Normally, the very last thing we would want to do is call your attention to daily market movements, because all of the worst investment decisions are made with a short-term focus. But I want you to be aware that we are following, very closely, the market events and their impact on your investment portfolio and ability to fund future goals.

As you no doubt heard in the media echo chamber, the U.S. markets recovered in dramatic fashion on Tuesday after the Monday free-fall. By the end of the trading day, the S&P 500 index was up 4.74%, and the technology-heavy Nasdaq index was up 5.29%. This helps to offset the roughly 16% drop over the past 11 trading days.

What does this mean? Here are some good questions that you may be asking yourself, and the best answers we can provide at the moment.

What's was different about Tuesday (when the market was dramatically up) from Monday (when the market was dramatically down)?

Very little from the standpoint of fundamentals. The economy is no stronger or weaker from one day to the next, corporate profits didn't make any radical adjustments, and the underlying worth of the business enterprises and debt obligations that you own have been pretty much the same throughout these Summer doldrums.

The main difference can be found in investor emotion, which is not predictable by any measure that we've been able to find. The Federal Reserve Board gave the optimists something to cheer about when it announced that it would maintain low rates--which tend to stimulate the economy by encouraging banks to lend and companies to borrow (and build factories, and hire

workers)--through mid-2013. That means that even though the federal government's expenditures won't be stimulating the economy during this time of highly-partisan belt-tightening negotiations, at least higher interest rates won't slam the economy into recession.

What about the ratings downgrade? Won't that hurt the economy and the markets?

Over the last couple of days, economists and veteran market watchers have been mocking the Standard & Poors rating agency. The kindest things they are saying is that the other rating agencies--Moodys and Fitch--have continued to give U.S. Treasury debt their highest safety ratings. Warren Buffet recently came out with a statement that U.S. government debt is the safest on the planet, and should be given a AAAA rating (which doesn't exist), rather than a downgrade.

Those who are less kind are pointing out that the downgrade came from the same Standard & Poors that rated boatloads of subprime debt as 'AAA', fueling the fire that resulted in the 2008 financial crisis. During that same period, it raised the credit rating of Bear Stearns an astounding 5 notches to AA- in March of 2008--the same month that the brokerage firm declared bankruptcy. Lehman Brothers, as a company, held an S&P rating of 'A' the week they went under, and the rating agency reaffirmed its 'AAA' rating on some of the company's securities just three days before it filed for bankruptcy and basically

defaulted on everything. It made similar mistakes with Merrill Lynch and Morgan Stanley (rated A and A+ respectively the week they had to be bailed out), and completely missed the problems with the Republic of Iceland.

Meanwhile, despite the downgrade, the prices of Treasury securities surged for the second straight day, sending the 10-year yield to an all-time low of 2.03% before it settled at 2.19%. Sophisticated investors around the world seem not to be worried that the U.S. will default on its debts.

Is this a good time to sell? Or to buy?

Some economists are saying that the market was oversold on Monday--which means that stocks, in general, were selling at a discount to their true value. But we aren't as confident that we know the true value of stocks in an uncertain economy, and it seems clear that emotions are ruling the recent market moves. It is possible that the emotions will take the markets further down, and it seems equally possible that the optimism we saw on Tuesday will continue.

It is worth remembering that in the first half of last year the market experienced a 17% decline (which was greater than the current downturn), and yet finished the year ahead by double-digits.

What should I do about these uncertain markets?

For now, we recommend that you not make any dramatic moves. Your account statements are reflecting the recent drop in market value, but this is a "paper loss" only. If you were to sell right now, you would be locking in a real loss. As we have discussed in the past, investing is a long-term process, and generally full of unpredictability and surprises. If you look back three years ago, the Dow had dropped to around 6,000. At the end of the day Monday, it was still around 11,000--almost double the low of a few years ago. Think back to all the scary headlines about double-dip recessions, sovereign debt crises in Europe, unemployment and all the rest, and you realize that the headlines were telling you to sell when it was much more profitable to hang on.

Is this time different?

Probably not. The world will come to its senses and hopefully we will be in a better place. However, we never know what is really going to happen, and I have found by planning for the things I can control – sharing time and love with friends and family, and living life fully from a place of love and joy, makes my world a better place while waiting for the rest of the world to get it together.

Sources:

Market rise and Treasury surge: http://finance.yahoo.com/blogs/daily-ticker/dow-jumps-430-points-stealth-fed-ease-202736590.html