WELLINGTON MANAGEMENT

AUGUST 12, 2011

VIEWPOINTS

Reality Bites: Implications of the US Debt Downgrade

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WHILE WIDELY ANTICIPATED, *the reality of the recent US debt downgrade by Standard & Poor's to AA+ has sent shockwaves across global markets. Global equities and commodities (excluding gold) have fallen 16% and 19% from mid-July levels, respectively, while government bond yields have rallied 37 bps and the Swiss franc has risen 14%. These dramatic moves reflect extreme risk aversion in the markets. But is the debt downgrade the direct cause of market turmoil or simply a catalyst? What else is going on, and what might we expect going forward?*

Markets Adjusting to Weaker Global Growth

We think the reality of the downgrade has deeply affected investor confidence globally, as opposed to explicitly raising borrowing costs or disrupting money funds via forced selling. Importantly, global macro troubles were brewing for months, including a weaker global growth outlook, growing stress in the eurozone, increasing fiscal austerity throughout much of the world, and a shrinking set of fiscal or monetary tools that can be used to forcefully support markets. These, we believe, were the real explosives — the downgrade was simply the spark that set them off.

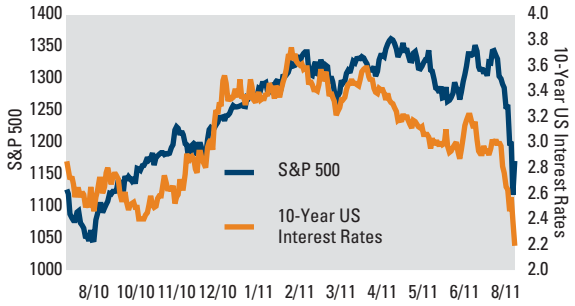
Global markets are now adjusting to the weaker growth picture. **Figure 1** shows that until April, the S&P 500 and the 10-year US Treasury bond yield had been moving in tandem, with declines in equities mirrored by falling yields and vice versa. Then, between April 11 and August 2, weaker economic data in the US and a fresh round of worry about European sovereign debt overtook bond markets and the 10-year Treasury yield dropped about 50 bps to 3%. Over that same period, the S&P 500 stayed in a 1250 – 1350 range as corporate fundamentals remained robust. European sovereign risks were discounted in European equities, as they lagged global equities by 10 percentage points over the past four months, but the risks to global growth were insufficiently direct to impact equities more broadly.

In the meantime, the global economy has been weakening. The Global Manufacturing Purchasing Managers' Index (PMI), which represents 86% of global manufacturing output, is now at its weakest level since July 2009, driven by softness in the eurozone, Japan, China, and the UK. Even more noteworthy is the decline in the new-orders component of the index, which has been a good indicator of future growth.

Within financial markets, scrutiny has been aimed at countries that have both high debt-to-GDP ratios and low growth prospects. Most recently, Italy has been in the spotlight given its 120% debt-to-GDP ratio, chronic slow growth, and weak prospects for future growth. Despite new efforts by the European Central Bank (ECB) to support Italy and Spain with significant bond purchases, we don't see this as a sustainable solution. The ECB will be reluctant to expand its balance sheet substantially and is more cautious about using unconventional policy tools than the US Federal Reserve. Plus, the expansion of the European Financial Stability Facility (EFSF) to €440 billion still falls short of the funds that would be required to finance Italy's debt.

Figure 1

The Disconnect Between Equities and Bonds Closes



Source: Datastream

Add to the list of Europe's problems the fact that industrial production — the driver of growth heretofore — is dropping. Taking all of this into account, we think Europe faces recession. These macro stresses are showing clearly in European bank equity prices, credit default swap (CDS) spreads, interbank lending markets, and poor liquidity in many corporate bond markets. We think these market forces will eventually push the ECB to be more aggressive, and that will be very important for European economies and markets. Even so, a long period of exceptional policy measures lies ahead.

Our Base Case: No Double Dip in the US

While a return to recession seems likely in Europe, we do not expect the same in the US. Equity market declines will probably knock down consumer spending and confidence another notch. However, we do not see our US recession signals flashing red. Consumer credit is rebounding, labor costs have risen modestly, profit margins are still healthy, and the yield curve between 2-year and 10-year bonds is very steep. These readings are inconsistent with an economy that is heading into a recession.

Two factors keep us cautious, however. First is the potential for turmoil to spread to the European banks, whose interconnectedness with the rest of the financial system could cause further market damage. While this is not our base case, our concern is that investors do not have clarity on European banks' exposures, and this uncertainty could freeze lending and cause markets to seize up. Bank stress is showing up in the European LIBOR-Overnight Indexed Swap spread (**Figure 2**), an indicator of banks' willingness

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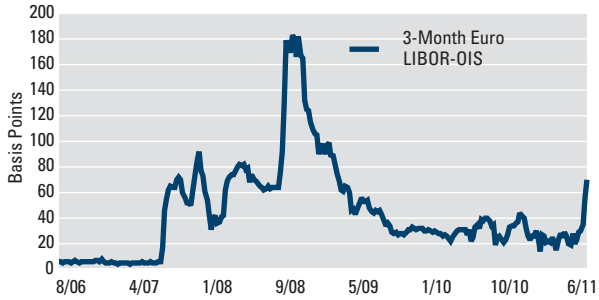
Figure 2

Interbank Lending Spread Reflects European Bank Stress



Source: Bloomberg

to lend money to each other. Second, the US unemployment rate is unlikely to drop appreciably, and with more bank layoffs expected, the risk is that unemployment remains elevated and spending remains weak.

Caution Warranted, But Opportunities Exist

So have markets sufficiently priced in the weaker fundamental outlook? In many ways they have.

Equities

While a large gap once existed between macro indicators and equity prices, it closed when equity prices corrected by 16% from the recent peaks. Furthermore, such rapid downturns, while unnerving, have most often been followed by periods of strong equity market performance. Historical data suggests that this month's equity market decline has discounted an exceptionally negative environment. Since 1899, there has been a 15% drawdown over the course of 15 trading days only 36 times, and many of those were during the Great Depression. What's more, over the 60 trading days following these 15% declines, equity returns tended to be positive, averaging 6.6%. That said, a positive result only occurred 60% of the time, and the average negative return was -10%. In today's environment, a short-term bounce is likely, but further downside is possible and will be heavily influenced by policy choices.

More fundamentally, trend valuation analysis suggests that equities are now priced for a sub-standard long-term growth environment. In the US, for example, we think of equities as being valued according to the prevailing macroeconomic regime. Prior to this month's correction, equity markets were priced for a "normal" environment of strong earnings growth, moderate inflation, and high productivity growth, as these were the conditions that prevailed at other times that equities were similarly priced. After this month's correction, equities were priced at a discount to normal valuations, but at a premium to structurally impaired periods like the 1970s. This implies that equity markets are vulnerable to perceptions of an impending crisis, but are now priced for a world in which growth will be structurally weaker than that which prevailed for much of the last 30 years. (**Figure 3**).

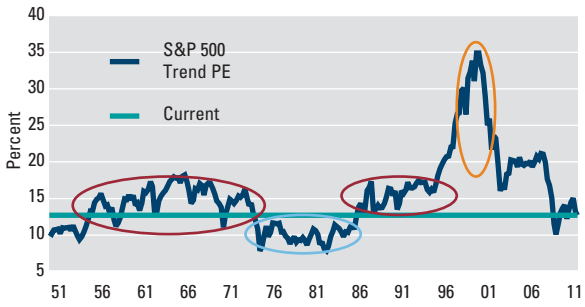
As a result, we find equities more compelling at these levels, though meaningful risks remain. We are focusing on areas where structural drivers are creating longer-term opportunities that offer capital appreciation, such as emerging market and natural resource-related equities, as well as those that offer some defensive characteristics, such as high-quality, dividend-oriented equities.

Fixed Income

In fixed income, we recommend focusing on liquidity and quality, given the uncertain environment. In the short term, we think government bond yields will track the equity markets closely. If equities rise, expect government bond yields to rise and spreads to narrow and vice versa. Longer term, yields near 2% on the 10-year US Treasury bond appear to be pricing in essentially no growth, assuming 2% long-term

Figure 3

Equity Valuations Reflect Weaker Growth Expectations



Source: Wellington Management

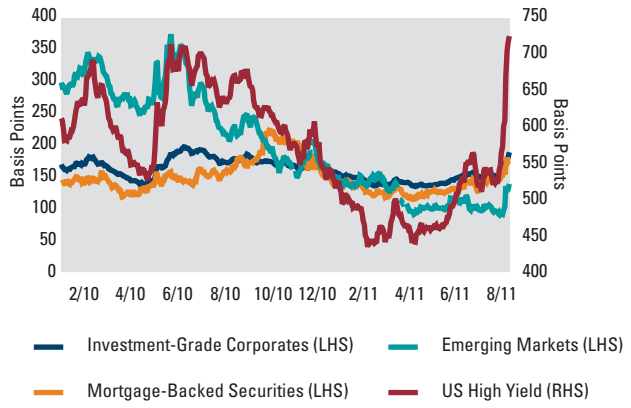
inflation implied in breakeven inflation rates and targeted by many central banks. Given that we don't expect a recession, however, we think this level is rich from a fundamental perspective, though we would recommend a neutral duration stance over the near term. Thirty-year US Treasury yields are attractive relative to the rest of the curve, given weaker growth prospects, continued pension demand, and the potential for the Fed to shift purchases to the long end.

Recent spread widening across credit markets has improved valuations substantially from the April tights (**Figure 4**). However, until markets stabilize, we remain cautious on higher-beta sectors like commercial mortgage-backed securities, high yield, and emerging markets. If risk appetite increases, high yield, with a 725 bps spread and 9.55% yield, is a sector where valuations look attractive relative to the fundamentals, given 1% – 2% expected default rates.

The Federal Open Market Committee (FOMC) statement on August 9 assured markets that policy rates would remain low at least through mid-2013. Ultimately, this should cause volatility to decline — a positive for mortgage-backed securities (MBS). At around 180 bps over Treasuries, with lower prepayments and limited credit availability, we think MBS offer good value. We also expect investment-grade corporates, especially those sectors removed from European bank issues, to continue to perform well. Corporate spreads are around 185 bps over Treasuries, 70 bps wider than June 30 (mostly driven by financials). Pension funds continue to demand long, high-quality corporate bonds to hedge their pension fund liabilities, and Standard & Poor's downgrade of US government debt has made high-quality corporates relatively more attractive.

Figure 4

Wider Spreads Reflect Weaker Growth Prospects



Source: Barclays Capital

Currencies

An important driver of currencies in this cycle will be the degree to which central banks aggressively utilize unconventional policies to address local market issues. The weak dollar trend, for example, has largely been a function of the Fed's aggressive policy stance relative to other central banks. With the ECB likely to be more aggressive and the Fed having largely exhausted its ability to ease policy, the dollar/euro cross has been rangebound of late. A decisively aggressive posture by the ECB could be a catalyst for a much weaker euro, as fair value estimates lie in the €1.20 – €1.25 range versus the US dollar. This would also negatively impact the Swiss franc, which has been trading like a safe-haven euro alternative, much to the displeasure of the Swiss National Bank, which has taken the extraordinary step of publicly considering the use of a peg against the euro to stem further appreciation.

Commodities

Commodities are trading like two different markets: gold and everything else. We expect the recent trend of gold appreciating amid market turmoil to continue, while normalization to a less impaired economy would bode poorly for gold. While many other commodities look expensive relative to history, they look reasonable given today's environment of extremely loose global monetary policy, strong emerging market demand, and limited demand destruction from high prices. The unique contours of the current cycle suggest that commodities will be more positively correlated to equities than they have been in the past.

Bet on Modest Positive Growth, Protect Against Crisis Fears

Markets have repriced to a slower-growth environment, which makes certain growth-sensitive assets attractive. But the potential for downside risk stemming from European policy uncertainty remains a serious concern. As such, we think that portfolios should be balanced between exposure to select riskier sectors that now offer better value and have strong structural underpinnings and less risky sectors with strong fundamentals that stand to offer protection in a downside scenario. In the riskier category, we include assets exposed to emerging markets and natural resources, as well as high-yield bonds. In the defensive category, we include high-quality dividend-oriented equities, mortgage-backed securities, government bonds, and high-quality corporate bonds.

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