



FINANCIALLY *Speaking*SM

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“A Perfect Storm”

During late July and early August, the markets went through a mini-meltdown and overall economic data was in a negative trend. Most people I spoke with wanted to know “why is this happening?” and “is this a repeat of 2008?” I’ve called recent events a “Perfect Storm” and have compared it to the year 2000 movie with that title where George Clooney and Mark Wahlberg battle a combination of weather conditions that created a killer North Atlantic storm. Similarly, we had a combination of events and data that created our own storm in the financial markets. In this edition of Financially Speaking, I will explain what I believe happened and why I don’t believe this is a repeat of 2008.

Best Regards,

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Events, Data and Emotion

The financial markets always respond to events and new data releases. But when too many unexpected events and data point in the same direction, market participants often react with emotion. I believe this is what happened in late July starting with the U.S. debt ceiling debate. The results of this political circus were universally disappointing and displayed to the world the current lack of statesmanship in the U.S. Then we had the quite substantial downward revisions for U.S. Gross Domestic Product (GDP) for last quarter and for much of the last 2 years. During all of this, Europe’s sovereign debt problems were in play, but a shock came when Italy, the world’s eighth largest economy, experienced rapidly rising interest rates based on its own sovereign debt problems. Finally, on August 5th, credit rating agency Standard & Poor’s downgraded U.S. Government debt from AAA to AA+. That, as they say, was the straw that broke the camel’s back. The market responded with a roller coaster of dramatic downs (mostly) and ups (fewer) between July 25th and August 8th that left the S&P 500 down nearly 17%.

Let’s start with the U.S. debt ceiling debate where U.S. citizens, and the entire world, had to ask themselves “can U.S. leaders move responsibly on the unsustainable U.S. debt situation?” The GDP downgrade made it painfully clear that the U.S. has not yet even returned to its previous GDP peak from 2007 – a level thought to have been reached in the fourth quarter of 2010. Concerns over Europe’s sovereign debt problems are not new and most analysts have assumed Greece, Ireland, Portugal and possibly Spain will default or require restructuring. But when Italy’s interest rates began rising, and it became widely reported they needed to rollover nearly 46 billion Euros of debt by October, everyone took notice. Lastly, the Standard & Poor’s downgrade of U.S. debt was a very questionable decision with many strings, especially to Europe, attached. Little wonder their CEO stepped down only two weeks later. In response to the downgrade, investors bid up the price of U.S. Treasury debt...a reaction many found ironic.

It’s not 2008!

This is all pretty bad stuff. But it is not like 2008. No, the panic of 2008 was the result of a global credit crisis triggered by sub-prime mortgage products and related derivatives helped by a shadow banking system. We now know that those products were very obscure and poorly understood. Highly-leveraged banks scrambled to determine exactly what their (and everyone else’s) exposure was. Banks didn’t trust each other in overnight lending, credit froze and a global banking crisis ensued.

While all of the problems I mentioned above have possible repercussions for the U.S. economy, only the situation in Europe has the potential to create a 2008-like global banking or credit crisis. However, unlike 2008 where complicated mortgage products and derivatives proved too much for even the most sophisticated investment banks to understand, the banking issues in Europe are related to sovereign debt. No crazy derivatives, credit swaps or shadow banking. We know whose debt is out there and who owns it. It will be a major event if/when some of the troubled countries in Europe restructure their debt, but the repercussions will be quickly understood. Countries and banks in trouble will be identified. It won’t be like the unknown risk environment of 2008 when no one knew who was in trouble or to what extent.

Could Europe become a financial crisis...yes. Might the global stock markets go down...yes. But those conditions don’t equate to another 2008-like panic. The world will always have problems and natural disasters with potentially bad repercussions. Equating slow economies and excessive sovereign debt to the extreme events from 2008 is a mistake for investors. Now is the time to manage your portfolio, avoid or hedge probable risks, but not avoid risk altogether.





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Jim will be speaking about retirement investments at the Your Financial Health event organized by Litchfield Bancorp from 6 to 8 PM on September 27th. Attendance is open to everyone. Learn more at www.litchfieldbancorp.com/community or call 860-393-9157

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