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Transcript of the July 14, 2011 Market Update for Investors

NATALIE Hi, thank you for joining us for our Economic and Market Update. Today is July 14, 2011. I'm Natalie Miller, Consulting Director for Private Client Services and today I'm joined by Erik Ristuben, our Chief Investment Officer for Client Strategies. Erik's responsibilities include the creation and management of investment solutions for Russell clients globally. And he's also a principal spokesperson representing Russell's investment process and insights with clients at industry conferences and also with the media. So my goal over the next 20 minutes is that we'll have a dialog about issues that you may be concerned about, issues you may be talking to your advisor about and provide our insight and help put things into perspective. Certainly as Erik and I spend time with advisors and investors the questions at the forefront of their minds deal with US government policy, market volatility, and global unrest, and so we'll try and touch on all of those in the call today.

Before we dive in, I'd like to take a moment to remind you that investing involves risk and principal loss is possible and that diversification does not ensure profit and does not protect against loss in declining markets. So Erik, thank you for being here.

ERIK Well, thank you for having me.

NATALIE Let's start with market volatility. Second quarter was a stressful ride for investors, both from a market return experience and economic news perspective. You've used the phrase often – the markets climb a wall of worry – can you talk a little bit about what you mean by that?

ERIK Yes, I think that the second quarter was just a continuation of the first quarter in terms of the news because we had the Japan earthquake early in the second quarter, but we had the Arab spring in the first quarter; we've had quite a few macro events that people have been concerned about. One thing I point out is that the Arab spring actually has so far not had the negative impact that people would have expected and I think one could argue that there's been actually some quite positive impacts of that whole phenomenon. The Japanese earthquake definitely had an impact, we'll talk I'm sure a little bit about what we saw that impact as, but the reality of the situation is that what I observe is we're up over 6% on the Russell 1000® Index, the actual returns for the Russell 1000 Index at the end of June were 6.37% year to date so that's a good, solid equity return. Over 4% of that came in the last five trading days of the month so there was a hurry to the close.

And I was sitting there in June thinking to myself – I think I've seen this movie before. Because I remember 2010…last year what we had was the market went up aggressively until April, at the end of April it rolled over when we saw riots in Greece, and then at the end of August we saw some traction. What we saw this year was through April the numbers were good for equities, really strong for equities, we saw a selloff from April to frankly the last week of June and then we saw people thinking – well maybe things aren't quite as bad as we expected. I think it's this whole notion of the new cycle being so focused on the big, macro issues – which I'm not here to tell anybody – these are real issues, these things really do matter – and how they're concluded will make a different in terms of what we can expect out of markets and what we can expect out of the economy.

To cut to the chase a little bit, our view is that most of these large issues are going to be resolved, not in an entirely attractive way, but they will get resolved in a way that isn't destructive for the markets and I'm sure we'll talk more about what I mean by that. The reality is that the new cycle is so relentlessly negative that people are looking at these things and thinking things are a lot worse.

We are in the midst of a mediocre economic recovery, which if you were listeners at the beginning of the year is exactly what we thought was going to happen. It's the soft patch that we experienced in terms of the economic data – which we definitely saw in second quarter – probably as a result of a number of things. One, it's just an organic soft spot in the economy; two, there was supply chain disruption because of the Japanese earthquake. The way a manager described it to me was that if the screen for your navigation system in your car is made in Hokkaidō Province, and you don't have one, you can't finish the car. That's what supply chain disruption means. That's beginning to ease its way through the system and behave better. And then we also saw oil prices get very high, we saw commodity prices in general in April really spike, by the time it got to the high point, oil had gone up $30 a barrel and there's kind of a rule of thumb in our industry – every $10/barrel oil prices go up, you take about a quarter-point off of your gross domestic product, your expectation for the economy. So you combine the two, some of the weakness we saw in second quarter economic data, disappointing…not enormously surprising. And we think we'll see some reacceleration of economic growth.

But what I'm saying is that at the beginning of the year we expected a mediocre recovery to continue, and candidly what we're going to get out of growth in the U.S. economy is going to be more mediocre than we thought but it's still going to be mediocre. That's kind of what we're expecting.

NATALIE It's still an economic expansion…

ERIK It is, just a really…not a very strong one and anytime your GDP number has one handle, one-point something lower, one doesn't feel comfortably different than zero. And the market does get concerned about that.

NATALIE The market seems to be reacting to events that are happening, as we would expect. Is that affecting the underlying company-level fundamentals?

ERIK You can think of it almost as a two speed recovery and it has a number of knock on effects, what I'm going to talk about…I'll mention a couple of them. The first is that the economic recovery has been extraordinarily tepid. The recovery in corporate earnings has actually been quite strong, very robust. The market is basically close to running through its peak earnings as measured by the S&P 500 Index. So you really have had – U.S. corporations and frankly corporations around the world have done an extraordinarily strong job of actually managing their earnings so from a fundamental standpoint stocks have actually done quite well. Unfortunately for the broader economy, one of the ways that they've done quite well is as their profits have gone up they haven't hired at the commensurate level you would expect. But I think to give people kind of a sense of what the intuition is around that, they're not hiring because corporations and people who run corporations are just like us and they see these macro issues playing out and they're not sure that now is the right time…even if they're stressed at capacity, even if they feel like they need more employees, they're hesitant to bring them on for lots of reasons. They're hesitant to bring them on somewhat because they're maybe not as confident that the growth will continue at the same rate…on the other side of that is that the CEO confidence survey for S&P 500 CEOs is as high as it's ever been. And small business confidence is actually increasing as well, so hopefully that's going to translate into hiring. But we don't expect the unemployment number to get substantively better for quite some time.

NATALIE Let’s move onto a discussion about those macro events. The debt ceiling debate is certainly top of mind. An interesting statistic that I read was that since 1960 Congress has raised the debt limit 78 times, with very little fanfare. What's different this time?

ERIK Probably 76 of those times with very little fanfare. The ones in the mid-‘90s when the government was shut down, that was a little bit more fanfare. Yes, I think that’s a perfect stat to introduce this. This is not unusual; this is not something that in and of itself is problematic. Why it’s getting so much heat and light now is that our fiscal house is not in order. The statistic most economists look at is the debt to GDP. Think of it as how much debt you own relative to your income, that’s basically kind of what it is. And that number’s gone up appreciably in the last few years for the United States and when it starts touching around 90% (your debt is worth 90% of your annual GDP) that begins to actually affect growth forecasts. And the one thing we all know is that that ratio cannot continue to keep going up because at some point you actually don’t buy anything; you only service debt. And you can't do that. So the question becomes when you get that high a level of debt is you’ve got to arrest the increase of that debt. That high of a debt ratio is something we’ve had before in the past, basically pre-war and kind of in World War II, but it is a very high number. It is something that’s manageable, it is only manageable if we actually stop adding more debt to the thing and having that ratio increase. So that’s really why this is getting so much amplification. It’s not the fact that we’re raising the debt ceiling; it’s the fact that politically people are wanting to take that event and maybe not doing it as an opportunity to highlight the real problem of – we’ve got to actually fiscally do some serious adjustments to what we’re doing.

NATALIE And so if the debt limit isn't raised, what are the ramifications of that? And is that a real possibility?

ERIK Okay, so if you think back in the ‘90s we had a very similar conversation around the government shutting down, everybody remembers that in ’95. And I think the politics of ’95 are important to recall because actually we’re in a presidential election cycle now; we’re five months out from the first primary? We’re in the presidential election cycle; we’ve been in it for a while but now we’re really in it. You’ve seen debates. The reality of the situation is that everybody’s aware of what happened in ’96…in ’95 the government shut down, in ’96 it looked like one party was held to blame for that and paid the penalty in the election. I think everybody’s aware of that. I think the other much more meaningful aspect this time is…in 1995/1996 we were right on the cusp if not actually in it (I don’t recall precisely) of a surplus. We were actually getting close to a surplus, we were still in a deficit but we were clearly moving towards balancing our budget and in a much more healthy fiscal standpoint. And so when we had these issues in the mid-‘90s the market didn't care that much. We have a lot more debt now; we’re not nearly in as good fiscal shape as we were. It’s not clear to me that our creditors are going to view us as the same credit risk they may have viewed us 15 years ago. And if we start doing things like even technically defaulting or not raising the debt limit, that may spook the market. And the ramifications are that it may permanently increase the interest rates we as a country have to pay other people to buy our debt. That makes the whole thing more expensive and not a little bit more expensive – a lot more expensive. That’s in addition to what the short-term reaction potentially could be which as the markets view it is a very negative event, interest rates spike, the market sells of. The thing is, I think every principal knows this, I'm not sure that anybody really wants to in these conversations actually – I think they understand that the potential downside for not doing it is so significant that they definitely want to do it but we’re in a political process. A rational person increases the debt ceiling because of all the bad things that can happen, hopefully you do it with an understanding that you are going to fix the fiscal problem. But right now you got to raise the ceiling because you're not going to have a solution in time. And that’s the rational economic argument, that’s not the political argument, that’s not anything else. But it’s a pretty powerful one and we’re pretty sure both sides understand that. We are confident they will reach an accord, that’s kind of our view on it.

NATALIE So across the seas, the U.S. is certainly not the only country having politically charged debates about debt.

ERIK You noticed that, yes.

NATALIE It's been over a year since the debt crisis in Europe began, with various countries reaching out to the European Union and International Monetary Fund for financial support. What's Russell's view on the most palatable solution for that?

ERIK Well, the least horrible solution. There's a lot of parallels between these two things. You're talking about fiscal problems and let's be clear here. Greece is in a much greater fiscal problem than the United States of America. Greece is frankly just not competitive as an economy. That doesn't mean it can't be; it just means it isn't currently. We are a competitive economy; we are competitive as an economy. We just owe too much money. There's a difference. They owe too much money and it's not clear they can actually grow enough to actually pay any of it back and that's what's happening. That debt's going to get, the Greek debt is not worth what it was sold at. The question becomes now – who owns that? Who's going to basically write the check between what it was worth and what it's now worth? That's real money; somebody's going to pay. And so Germany and France (frankly core Europe) is going to write the check principally. They're going to do it probably by creating a central fiscal authority. They're going to probably float Euro Bonds backed by all the members of the European Union. Right now what happens is that Germany sells its own bonds denominated in Euros; France does; Greece does (and nobody wants the Greek debt right now) and that's why we're in this trouble. So the reality is what they'll do is raise a whole bunch of money through this Euro Bond and they'll use that money to basically pay for some of the difference between what those Greek bonds were sold at and what they're worth.

The other way it's going to be made up is that people who own those bonds are going to take a haircut; they're going to share the pain. The third way it's going to be addressed most likely is that Greece is going to have to live within its means, right? And we're using Greece but there's other countries as well. So the austerity budgets, if this is too technical I apologize to the audience. If you cannot deflate your currency, if they have the drachma, what they could do is inflate the drachma, they could have inflation, they could deflate the drachma so they would be paying off in worthless drachma. I think most people are familiar with how you do that. They can't do that; they're part of the Euro. And the Euro's not going to do that. So they actually have to really deflate, which means they have to reduce their standard of living. And the reality is even if they did it to the point of maximum pain, it still wouldn't be enough. They need those two other things to happen. But they need to show they're willing to do that before a German citizen's going to be willing to write a check to bail them out. And may never be willing, at least Angela Merkel's will be willing to say that you've done enough. You've seen this political brinksmanship happen, and that's what it is, Merkel taking a very, very hard line. If you watched right before the vote of confidence in Greece, she had an incredibly hard line and just before it broke, the systems broke – she backed off. But that gave the government of Greece the ability to say – look, they're serious. We have got to pass this austerity budget. So they got the vote of confidence, they got the austerity budget passed. You're going to see that kind of brinksmanship occur over and over again. But you're also seeing discussions around a Euro Bond, you're already seeing that. You're seeing discussions around how you restructure the debt, you're seeing that and Greece is doing the austerity budget. So you're seeing those three things that we talked about actually beginning to take shape; it'll take longer than anybody wants for it to actually be done, but we're confident it will be done.

If they don't do it…why would Germany write a check? 60% of German goods are sold to other European Union countries, right? Destroying those countries is destroying half their customer base. It's kind of that simple and yet it's much more complicated.

NATALIE So there's a vested interest for all three of those things to happen?

ERIK Yes. There's no one incented in taking down the system. There's just no one incented; it'll be painful and expensive to do it but the alternative is so bleak that it's hard to imagine anybody would ever do it, but it is a political thing so keep watching the space. We're seeing what we expected to come out beginning to come out and we hope it continues; we expect it to continue.

NATALIE But it's not an overnight solution. This is a multi-year…as it works through –

ERIK Oh yes. I think Churchill was fond of saying – you can always count on the Americans to do the right thing after they've explored every other option. I think that Churchill probably would have said he expects the Americans to do this kind of thing before other people (laughter). They'll do it, it'll just take a long time…17 different countries, 17 different languages, we're having this debate internally in our country, we all speak the same language we're all the same country. It's going to take a while.

NATALIE I think a good closing question, certainly as we've talked about market volatility and the political discussions going on in the U.S. and in Europe, they're not necessarily happy topics. What would you say to investors who are scared, who are worried that this is beginning to look like another 2008?

ERIK What I would say is a couple of things. I would remind people to look at last year. The market was off 16% to 20% depending on what you looked at but the Russell 1000® Index was off over 16% from its high to where it got in the summer of last year as people became very concerned about the double dip. If you had made the decision at that kind of maximum pessimism threshold to get out, you would have missed a 20%+ market move at the end of the year. The market moved basically almost vertically up from the end of August to the end of the year, and that's a real cost. These are real issues and bad things are definitely a possibility; we don't believe they're a probability. So we believe that exiting the market, doing something precipitous is much more likely to cost you money and frankly potentially a lot of money than to kind of play the probability and stay invested. But I think the key, and we talked a little bit about this…what I would tell you is hopefully this conversation's helpful. Listen to people who you trust, listen to your advisor, ask them to explain their view on what's going on as we're trying to do with the audience today. Because the news isn't going to help you. The news channels aren't going to help you; they're just going to try to scare you so you watch more news. So really begin to think…I'm the son of a history professor and I think that understanding things makes things less frightening and so I'd really spend some time on that.

And the reality is – if the market goes down 20% over the next three months, if you don't sell and it goes back up in a year or so, other than the emotional toll it takes on you, it doesn't really necessarily (for many investors) have an impact. Even for people in retirement, it has a huge psychological impact. It's not clear it has the same financial impact and separating those two I think is – paper losses are paper losses until you make them good. Just kind of keep that in mind. It's very hard to do and I think the way we can help you not do it is by having these kinds of calls and talking about our viewpoints.

All that said, these are real issues. I can't wave a magic wand and make this stuff go away, it won't go away immediately. Next year there will be other issues that will be equally real and potentially as negative. As you said at the very beginning, investing involves risk. And that risk is a risk to lose money; it's also a risk to make money. And in fact that level of risk and uncertainty is required to get a rate of return. It's hard to emotionally accept, it's hard for us, and we've been doing this for a very long time.

NATALIE Right. Well thank you Erik.

ERIK Thank you.

NATALIE I want to thank our listeners. Continue to keep those dialogs going with your advisors about how to make sure that your portfolio still stays on track with the financial goals that you set up for that. The views that we've shared today could change at any time based on market or other conditions and are current as of today. Opinions we expressed are not necessarily those held by Russell Investment Group, its affiliates, or subsidiaries and accuracy and completeness cannot be guaranteed. The information, analysis, and opinions expressed on this call are for general information only and not intended to provide specific advice or recommendations. Securities, products, and services are offered through Russell Financial Services, Inc., member FINRA, part of Russell Investments. Thank you and that ends our call.

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