

The Great Perception Recession of 2011

- Volatility continues to rattle markets
- Perception often differs from reality, but can sometimes shape it

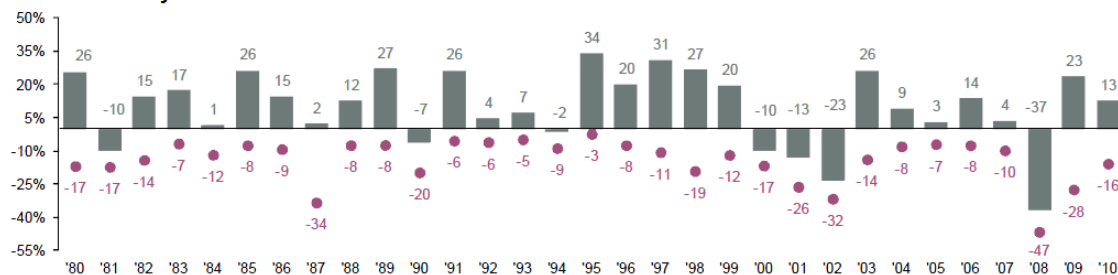
What is happening?

Over the past two weeks we have seen amazing swings in the market unfold over the course of a single day. These intraday swings would cause any normal person to have heart palpitations if they occurred over the course of a month. As of August 10th, **investors had lost \$2.8 trillion in value** since the stock market slide began on July 22. (*Yahoo! Finance*)

The chart below shows historical calendar year returns (grey bars) and intra-year market declines or corrections (red dots). While by no means a guarantee of future results, it is important to recognize that volatility is normal. Despite an average intra-year drop or correction of 14.3% since 1980, markets have finished in positive territory in 24 of 31 years. (*JP Morgan*)

- The intra-year decline of approximately 16% (as of August 11th) is well within the normal realm of expectations.

Chart 2: Intra-year Declines vs. Calendar Year Returns



Sources: Standard & Poor's, FactSet, J.P. Morgan Asset Management.
Returns based on price only and do not include dividends. For illustrative purposes only.
Data are as of 8/7/11.

In times of inexplicable turmoil people often look for patterns. Being just three years removed from the great recession of 2008, how can we not all feel we are in the early stages of a repeat performance? Many today perceive the same three risks we experienced just three years ago:

- **The perception of bank failures**
As was the case a few years ago, rumors of bank trouble abound. Back then US banks were overwhelmed with the overly aggressive loans given to subprime homebuyers. Now popular perception is that **European banks are loaded with bad loans** given to subprime European nations, and some French banks might actually be at risk.
- **The perception of an impending recession**
In 2008 we were already two years into a real estate collapse and a rapidly slowing economy. Now we are two years into an anemic recovery that **appears to be stalling** and perhaps "double dipping."
- **The perception of a leadership vacuum**
Three years ago it seemed leadership was asleep at the helm, and whenever the government announced a new strategy to deal with the problems, it led to further market disappointment. Today it once again seems that we have **no one that is stepping up with a compelling vision** to soothe the markets.

What is real and what is not?

Sometimes perception can become reality. When the security of banks is called into question, there is the possibility of a run on those banks that are perceived as unsafe. We all remember what happened with Bear Stearns and Lehman Brothers. When those once-respected institutions lost the trust and confidence of the market, clients pulled their assets and these at-risk banks were no longer able to fund their operations. This led to the majority of banks abruptly pulling back lending, exacerbating an already weak economy. Consumers and corporations hoarded cash and slowed investments and spending which further weakened an already slowing economy.

What is real today?

We can categorically state that we are in a very different place today than in 2008. So let's separate perception from current reality:

- **The reality of the bank crisis**
The banks in the US have spent the last three years **cleaning up their balance sheets**. There is still much work to do, but **much of the pain has already been suffered**. Over the past few years, banks have been making much stricter, more responsible loans. European banks may indeed have major debt issues, but anyone would be very hard pressed to compare the magnitude of this issue to the massive write-downs that occurred during the 2008 bank crisis.
- **The reality of the economy**
We are clearly still in a sluggish economy that has been stubbornly unable to create jobs and grow. This is true in large part because banks have been less comfortable lending since the last recession, and companies and consumers have been building up cash just in case they face another economic crisis. No bank, company or person wants to experience a repeat of the 2008 debacle.

Corporate earnings today are higher than they were prior to the last collapse, even though the S&P 500 is over 20% lower. In our opinion, **valuations are far more reasonable** than they were a few years ago and **corporate cash has never been higher**. In addition, Americans have been saving, home ownership is at the lowest level it has been in decades and our debt levels as individuals have been dropping precipitously. This debt reduction will continue for years to come, but it is expected and anticipated by the markets.

While the economy is clearly slowing, and the recent debt ceiling fiasco has certainly caused many to defer big financial investments, we believe it is a temporary lull. It may be safe to presume that **in the current quarter the US economy actually shrank**, but it is not rational to assume that this will be true over the long term. In fact, if the perception changes just a little, we could see a **surge in catch-up spending over the next year**. However, the fact remains that during a recession, corporate earnings and the equity market both typically go down on average between 25% and 35%, so a recession is already in the process of being priced in. (David Rosenberg)

- **The reality of the leadership vacuum**
We clearly are all frustrated by the lack of leadership to create a unified vision to help dig us out of the current mess. There has been no call to action and no apparent urgency in our government to proactively cope with the major issues facing our country. This has led to an unprecedented downgrade in our debt, which, while embarrassing to all of us Americans, doesn't change the fact that we set the standard for the world and we are the world's reserve currency. Regardless of our rating, the world's interest rates are benchmarked to our treasury interest rate. Despite all the noise from detractors, that will not change anytime soon.



What is the prudent way to act at a time like this?

We are pragmatists first and foremost. We intend to do what we have always done: concentrate on making prudent, well-informed and objective decisions that help to protect you from harm. In our investment strategies that offer downside protection, we have been increasingly scaling to more conservative investments for weeks, and for those with more passive portfolios we are well diversified into bonds, which have helped to dampen the declines in stocks. To be clear, we do not believe this is a redux of the 2008 debacle, but we are being cautious just in case. Finding market bottoms is a messy process. It is possible that our worst fears may be confirmed over the coming weeks and months, but given the current situation it is not extremely likely.

Now is not a time for emotional decisions. If you are nervous, please speak to your wealth counseling team. We are here to help you make good decisions that help you thrive in good times and bad. Our teams around the country have access to some of the best minds in the country to help you with any challenge you might face.

Remember, good decisions don't always feel good at the time. There is usually an immense benefit to rational judgment, especially when it comes to financial decisions.

Thank you for your trust and confidence.

Regards,

The United Capital Investment Committee

Important Disclosure:

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