PERSPECTIVES

A newsletter for the clients and friends of Mercer Advisors

MERCER ADVISORS™

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The Fear Factor

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As a result of Standard & Poor's downgrade of U.S. government bonds last Friday, many investors have decided to sell their stocks in highly profitable companies in order to purchase (downgraded) U.S. government bonds. Ironically, they have chosen to seek financial security in the very thing that is perpetuating the current market selloff – downgraded U.S. government debt!

Clearly, no one can predict the future. However, what Mercer Advisors can provide is something infinitely more valuable – knowledge, clarity and context.

The Latest

Yesterday, the Federal Reserve Bank took a definitive and unprecedented position in announcing that it would maintain low interest rates for two years due to slower than expected economic growth and employment recovery. This announcement, in conjunction with Bernanke's stern reminder that "monetary policy is not an economic panacea", clarifies some seminal points:

- Congress and the Administration must acknowledge and assume accountability for the far-reaching effects of an over-leveraged federal government
- They must then move forward collectively to create long-term solutions to the divisive issues surrounding debt, spending, taxation and entitlement programs
- The Federal Reserve has done what it can to contribute to the solution.

The Reality

In our Friday, August 5th Perspectives newsletter, *Is the Debt Ceiling Made of Glass?*, we outlined the lack of substance contained within Congress' new debt ceiling/deficit reduction plan. We also identified how a potential downgrade in credit rating could be of little consequence over the long term as evidenced by other countries that have experienced a similar downgrade in the recent past.

Standard & Poor's proceeded with a ratings downgrade for U.S. government debt – from AAA to AA+ – exactly as they indicated they would if Congress was unable to agree to a package to reduce the federal deficit by at least $4 trillion over the next ten years. Alternatively, Congress passed a deficit reduction plan to reduce the deficit by only $2.1 trillion over the next ten years. The only real surprise in this fiasco is not that Standard & Poor's decided to downgrade U.S. government debt, but that the current Administration was surprised by S&P's highly telegraphed decision.

It is also important to reiterate that S&P's action was not the result of the U.S. Government's ability or intent to pay on its debt obligations, but rather a response to the utter lack of political consensus and cooperation displayed on Capitol Hill regarding how to repay the debt and reduce the deficit.

The Effect

Let's ask ourselves what has really changed over the course of one week regarding our long-term investment holdings. The true value of a company's stock resides in its (future) earnings. Nothing of any great substance has changed in Corporate America as a result of the downgrade of U.S government debt. Once again, we must remind ourselves of this significant distinction: The fate of the U.S. government remains separate and distinct from that of Corporate America.

Corporate America is prospering largely due to the tough lessons learned from the financial crisis of 2008. Subsequently, U.S. company profits are among the highest they have been in decades.

Many American corporations have focused and capitalized on prospects for growth that continue to present themselves outside of the U.S. Furthermore, numerous shocks to the global economy during the first half of 2011 notwithstanding, corporate profits have remained resilient and strong. Corporate America has reported operating earnings that have outperformed projections for the second quarter of the year – despite slower industrial productivity and weaker overall economic output. Corporations continue to hold their cash, maintain lean balance sheets and avoid debt or excessive leveraging.

Despite surging oil prices, Japan's devastating earthquake/tsunami, extreme weather events across the U.S. and Australia and now, Standard & Poor's unprecedented downgrade of U.S. government debt (and subsequently, one of the largest stock selloffs since 2008), the year-to-date change in global stock market indices has been a far cry from what we experienced in 2008. Consider the chart below:

Market/Index	2010 Close	Prior Week	As of 8/5	Week Change	YTD Change
DJIA	11577.51	12143.24	11444.61	-5.75%	-1.15%
NASDAQ	2652.87	2756.38	2532.41	-8.13%	-4.54%
S&P 500	1257.64	1292.28	1199.38	-7.19%	-4.63%
Russell 2000	783.65	797.03	714.63	-10.34%	-8.81%
Global Dow	2087.44	2088.82	1906.46	-8.73%	-8.67%
Fed. Funds	0.25%	0.25%	0.25%	0 bps	0 bps
10-year Treasuries	3.30%	2.82%	2.58%	-24 bps	-72 bps

Sources: Morningstar, CNN.com, Google Finance

The Irony

Despite the purported increase in risk associated with investing in downgraded U.S. government debt, investors have voted with their money and have subsequently pushed up the price of (downgraded) U.S. government debt.

Furthermore, despite dire proclamations to the contrary, global investors have also chosen U.S. government bonds and the US dollar as a safe haven for their wealth to weather the current storm. Despite the rating downgrade, U.S. currency and U.S. government debt remain some of the highest quality safe investments available in the global marketplace to date.

The Silver Lining

Even in light of the sobering realities of the past week, there is room for optimism. The U.S. government is acutely aware of the need to rein in and reduce our sovereign debt. Corporate balance sheets are healthy and controlled. Corporate America continues to prosper while the process of enacting legislation continues to move forward, albeit slowly and messy at times. Such is the democratic process.

Remember that this remains a political issue, not a financial one. We are going to be much better as a people, a country and as a global community once we emerge from the other side of the current storm.
