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	YTD 2011 Return	2010 Return
Dow Jones Industrial Avg	-5.7%	+14.1%
S&P 500	-10.0%	+15.1%
Nasdaq Composite	-9.0%	+18.0%

  

	Month End 2011 Yield	Year End 2010 Yield
10-Year Treasury Yield	1.92%	3.35%
3-Month T Bill Yield	0.02%	0.13%

**Stocks Drop for Quarter**

Stocks ended September on a down note and had their worst quarterly performance since the fourth quarter of 2008. The S&P 500 Index was down 13.9% for the quarter, and is now down 10.0% for the full year. Small cap stocks, which tend to be more volatile than the larger cap stocks that make up the S&P 500 Index, were down 21.8% for the quarter and are down 17.1% for the full year. Foreign markets didn't fare any better, with the MSCI EFA Index of developed markets down 20.6% for the quarter and down 16.3% for the year, while the MSCI Emerging Markets Index was down 26.3% for the quarter, and is down 25.6% for the year.

Concerns over the slowing global economy and that the debt crisis in Greece will spread to other countries were the primary factors contributing to the sell-off in the quarter. While it appears the market is anticipating that eventually Greece will default on its debt, the main uncertainty is the aftermath of this default and how it will be contained. Greece is a relatively small economy within Europe, but the main worry is Italy, which has much more debt outstanding with the major European banks. The leaders in Europe are working towards putting together a plan to shore up their financial system, with Germany being a key player.

Back in the U.S., corporate profit growth still remains healthy. First half earnings were up in the mid-to-high teens, and expectations are for third-quarter earnings to be up in the range of 12-14% over last year. As earnings reports begin to be announced over the next

few weeks, the key to watch in addition to the actual level of earnings and revenues relative to expectations will be future corporate guidance. It will be important to monitor how corporate CEO's gauge the health of the world economy and its resulting impact on their future corporate profitability. Barring a major ratcheting down of earnings estimates, the S&P 500 appears undervalued relative to historical norms, with a current PE of 12.

**U.S. Economy: Slow Growth**

In late September, the Commerce Department issued its final reading on second-quarter GDP with growth reported at +1.3%. This was an increase from its previous estimate of only +1.0% and slightly higher than expectations. Somewhat stronger consumer spending and a slight pickup in construction spending were the main drivers behind the upward revision. In addition, the government reported that consumer spending rose 0.2% in August, though personal income fell 0.1%. The health of the consumer is vitally important to the economy since consumer spending represents approximately 70% of GDP growth. This data will be important to track as we head into the all important holiday shopping season. Last week, the weekly jobless claims fell 37,000 to 391,000, the lowest level since April. The decline was probably due to some seasonal adjustments and other technical factors, but any improvement in the job picture would be encouraging news after several months of disappointing data. So while recent economic data points have been somewhat encouraging, the economy is still only expected to show modest growth over the next few quarters.

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## Bond Yields Near 60 Year Lows

Slow economic growth and an aversion to risk continued to push down bond yields in the quarter. The 30 year government bond yield is now down to 2.91%, while the 10 year government bond yield is at 1.92%, both near 60 year lows. In an effort to stimulate the economy, the Fed has initiated programs to bring down interest rates and to keep rates down for an extended period of time.

## Impact of Sovereign Debt Rating Changes

In early August, S&P downgraded US government debt from a top-rated AAA to AA+. In the weeks preceding the event, some market observers expected a downgrade to result in higher interest rates. However, after the downgrade, yields on US government securities actually fell as investors around the world fled to the safe haven of US bonds.

These events raise questions about whether changes in sovereign debt ratings impact the financial markets. The short answer is that results are mixed, and that many other factors are involved.

Regarding bond markets, history offers examples of major developed countries that experienced a credit downgrade without a significant rise in interest rates. Examples include Australia, Canada, and Japan, which lost their top ratings in 1986, 1992, and 1998. Other research suggests that countries with high credit ratings may withstand a downgrade better than countries with lower ratings. One study looked at sovereign credit rating downgrades since 1990 and found that bond yields changed little among countries downgraded from the highest triple-A rating. However, countries with lower credit ratings (single A or below) experienced significant interest rate increases following their downgrade.

### Stock Market Impact

Below is a chart that summarizes stock market performance of respective countries before and after a ratings change. It is based

upon a study of ratings changes made by Moody's from 1983 to 2009. During the twenty-seven-year period, the ratings agency made seventy-one upgrades and twenty-five downgrades to governments in the developed and emerging markets.

The study identified the date of each change and logged each country's market performance in the twelve months before and after the event. Each country's market returns were compared to the respective market index and the excess return averaged for all events.

### Equity Market Performance Before and After Moody's Ratings Changes

1983-2009	Cumulative Return in Excess of Market	
Sovereign Bond Rating Change	12 Months Before	12 Months After
Upgrade	13.83%	3.87%
Downgrade	-6.56%	3.73%

The results show that stock markets of upgraded countries outperformed their respective market index in the twelve months before the rating change, while stocks in downgraded countries aggregately underperformed the market index before the event. However, cumulative returns in the twelve months following a ratings change were almost the same for both upgrades and downgrades. This data suggests that market prices reflect all available information and expectations about a country's economic prospects—including the possibility of a ratings change before it actually happens. By the time a country's debt rating is changed, the market has already integrated the news into prices. After the event, markets did not appear to perform much differently, in either case.

*This article does not qualify as, nor should it be construed as, tax advice. Contact a professional tax advisor about your specific situation.*

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