

Holding Steady in the Face of Market Volatility

Anyone who has even a passing interest in financial news and the investment world knows that we are in a period of unusual events and uncertainty. Although some recent developments are unprecedented, and the headlines can be alarming, history counsels against overreacting. It's important to approach the tumult in the financial markets with an eye toward the practical and not the emotional.

Because so much has happened in a relatively short period, you may have had trouble keeping track. This summary may help bring you up to speed.

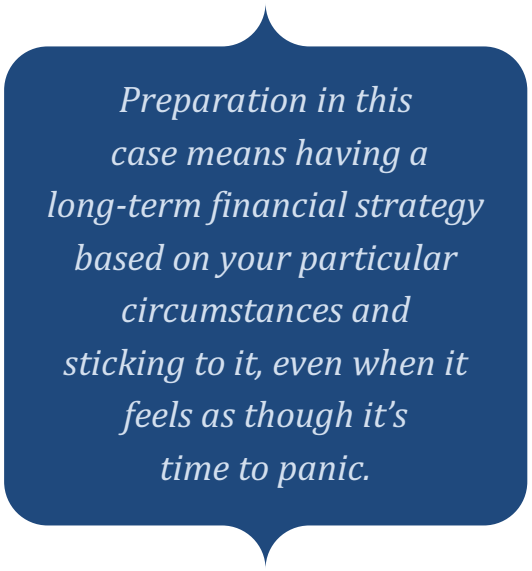
What Happened

Over the past few months, the nation watched anxiously as lawmakers wrangled over a proposed increase in the debt ceiling, a statutory limit on the amount the U.S. Treasury can borrow from the public to cover the gap between what Washington spends each month and the amount it collects in tax revenues. Ordinarily, raising the debt ceiling is a fairly routine process but this time was made more contentious by an earlier warning from Standard & Poor's Ratings Services of a possible credit downgrade. In April, the credit rater lowered its outlook for America's long-term credit rating from "stable" to "negative," warning that the country was at risk of having its triple-A credit rating downgraded if the government could not agree on a plan to lower its long-term deficits.¹

Soon after a debt-ceiling compromise was reached on August 1, the stock market entered a highly volatile period, as investors focused on other troubles that had been eclipsed by the debt-ceiling debate, such as continuing disappointment in the job market, eurozone sovereign debt problems, and weak growth in U.S. gross domestic product. The Dow Jones Industrial Average ended the week down almost 6%.²

After the market closed on Friday, August 5, Standard & Poor's downgraded — for the first time in history — the U.S. government's credit rating to AA+, one notch below AAA, the highest possible credit rating. S&P noted that the debt-ceiling compromise had not gone far enough to address its concerns.³

When the markets opened on August 8, trading was volatile, as expected, but also aggravated by S&P's downgrade of Fannie Mae, Freddie Mac, and 10 of 12 Federal Home Loan Banks that were



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propped up by the federal government after the 2008 financial crisis. The Dow fell more than 600 points, the worst one-day point loss since December 2008 and the sixth biggest point drop in its history.⁴⁻⁵

The following day, August 9, the Federal Reserve pledged that it would leave benchmark interest-rate targets near zero for at least two years — an uncharacteristically specific time frame — and hinted that it may take further steps to prop up the economy, which the Fed chairman acknowledged could be slow to recover.⁶ The Dow closed up 4%, the biggest gain since March 2009.⁷ But volatility resumed the following day and may continue until it becomes clear how Washington plans to deal with the debt crisis, or until the economy shows stronger signs of recovery.

The Finer Points

Because the S&P downgrade of U.S. creditworthiness was unprecedented, some investors have reacted with panic. Here are some lesser-known points that may help put the situation in perspective.

- **When a borrower's creditworthiness is downgraded, the interest rates it pays to borrow money could be expected to increase.** But it's not clear whether or when this will actually come to pass. Yields on Treasury debt — the very same downgraded by S&P — fell to an all-time low in the wake of the downgrade as investors searched for protection against volatility.⁸ Yields move in the opposite direction of prices, so falling yields can signal increased demand as investors bid up prices. This is a reminder that investors — not credit-rating agencies — determine bond yields.
- **Standard & Poor's said the United States failed to go far enough in drafting a debt plan to address the nation's borrowing trajectory.** Although the United States clearly has a debt problem, so do other wealthy nations. The United Kingdom and some European Union nations are also facing sovereign debt troubles yet retain their triple-A ratings.⁹ Sovereign debt problems in other nations mean that U.S. debt may still appeal to many investors.
- **The difference in credit risk between AAA and AA+ is negligible.** Both indicate very low risk of default. However, the fact that the world's largest economy, issuer of the world's reserve currency, was downgraded can be tremendously important from a psychological standpoint. It's not clear what the long-term effects will be.
- **Moody's Investors Service and Fitch Ratings, the other two major credit-rating agencies, have not downgraded the U.S. credit rating.** This means they still consider the United States to be among the most creditworthy borrowers in the world.

How or whether you will be affected — or whether you should consider making adjustments — will depend on your specific circumstances and risk tolerance.

- **After S&P told Treasury officials about its decision to downgrade U.S. Treasury debt, Treasury officials contended the calculations included a \$2 trillion error.** The fact that S&P changed its rationale for the downgrade after this was pointed out, but proceeded anyway, has led to accusations that S&P's actions were politically motivated.¹⁰
- **The downgrade, the debate over spending and taxes, and volatility in the global financial markets are good indications that solutions may be forthcoming.** Investors are telling policymakers that it's time for structural reform and to stop papering over budget imbalances with debt.
- **Treasury bills are backed by the full faith and credit of the U.S. government as to the timely payment of principal and interest.** This has not changed.¹¹ (The principal value of bonds may fluctuate with market conditions. Bonds redeemed prior to maturity may be worth more or less than their original cost.)

What Should You Do?

As mentioned earlier, it's important not to let emotion determine how you may react in the near future. This is not to say that the wise approach is to place one's head in the sand and wait for the calm to arrive. But time has demonstrated that a solid defense against market volatility is to be prepared for it — and expect it. Preparation in this case means having a long-term financial strategy based on your particular circumstances and sticking to it, even when it feels as though it's time to panic. Panic is not only ineffective, but it can be costly. Fleeing a declining market carries the risk that you may not be in a position to take advantage of a recovery.

Sound advice such as maintaining an appropriate asset allocation and a well-diversified portfolio might be of little consolation when you see your account balance falling. But the alternative, selling when prices fall and waiting for them to recover before you venture back

into the market, may only worsen the situation. Asset allocation and diversification do not guarantee against investment loss; they are methods used to help manage investment risk.

Of course, how or whether you will be affected — or whether you should consider making adjustments — will depend on your specific circumstances and risk tolerance. In fact, the current situation may represent an opportunity for your portfolio.

Although it's understandable to be concerned when you see the kind of market volatility we have witnessed recently, be careful not to let your emotions take over. We can help address your questions and concerns.

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1, 3, 9) Standard & Poor's, April 18, 2011 and August 5, 2011

2, 5, 7) Yahoo! Finance, 2011, for the period 10/1/1928 to 8/10/2011. The performance of an unmanaged index is not indicative of the performance of any particular investment. Individuals cannot invest directly in an index. Past performance is no guarantee of future results. Principal value and return will vary over time, particularly for long-term

investments. Actual results will vary. Shares, when sold, may be worth more or less than their original cost. Investments seeking to achieve higher rates of return also involve a higher degree of risk.

4) ABC News, August 8, 2011

6, 8, 10) *The Wall Street Journal*, August 10 and 7, 2011

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