

A Note Regarding the U. S. Credit Downgrade

After the markets closed this past Friday, Standard and Poor's downgraded the credit rating of the United States from AAA to AA+, sending ripples through financial markets around the world that ultimately grew to tidal wave proportion on Monday. Typically, S&P downgrades a company or country based on the ability of the creditor to repay its debtors, but that was not the case this time. Instead, the S&P's downgrade of U.S. debt was based almost entirely on the political turmoil in Washington. In particular, Standards & Poor was concerned about the dysfunctional recent attempts to arrive at a debt deal, as well as the fact that the deal we finally ended up with does almost nothing to address our longer-term budgetary problems. In other words, the S&P essentially downgraded Washington, not the creditworthiness of the U.S., and we think this is a mistake. The creditworthiness of the U.S. remains the highest in the world, and S&P's decision fails to recognize this. Instead, they chose to fundamentally alter the process by which they assign bond ratings, shifting their focus from credit risk to political risk. This was misguided in our view. It's clear the rest of the market feels the same, as U.S. Treasuries rallied while global financial markets were in free fall on Monday. The bottom line is...U.S. Treasuries remain the safest asset on the planet and yesterday's Treasury market activity only served to confirm this.

Uncertainty Breeds Volatility

Misguided though it may have been, Standard and Poor's downgrade clearly injected more uncertainty into an already fragile global market and, as always, we saw that uncertainty breeds volatility. However, it's important to remember that the driving factors behind Monday's selloff were purely psychological and were not based on economic fundamentals. This was echoed by Billionaire investor Warren Buffett who believes the market is irrationally over sold. In addition, he believes the S&P made a mistake in lowering the U.S. credit rating, stating that U.S. debt should be considered triple-A (or even quadruple-A if there were such a thing).

Volatility Breeds Fear and Irrationality

Yesterday, investors reacted to the U.S. debt downgrade by selling stocks, which seems odd in light of the fact that U.S. corporations have been enjoying one of their best years in history and continue to surprise on the UPSIDE. For example, with roughly 80% of the companies in the S&P500 index having now reported 2nd quarter financial results, here are a few interesting facts:

- The average positive earnings surprise has been 4% above the consensus estimate of the analysts.
- For the quarter, aggregate corporate earnings and revenue are both up about 13% from the year-ago period.
- Corporate cash balances remain at record levels and companies continue to buy back shares and raise their dividends, both indicating that corporate execs remain bullish about the prospects for their firms.
- In the last week of July, analysts raised earnings estimates for all ten S&P 500 sectors, indicating they too believe companies will continue to do well.

The point is, American corporations (and foreign ones for that matter) have shown they can make a lot of money even if the economy is stagnant, and they continue to do so. Yet on Monday, investors ignored the fundamentals and allowed fear to drive their decisions, much like we saw back in 2008 and 2009. However, given the strength of corporate balance sheets we think it's very unlikely that we'll revisit the lows experienced in 2008. That said, the capacity for short-term irrationality on the part of investors seems impossible to underestimate. Just remember, publicly traded companies today are in far better shape than they were in 2008. Additionally, the average price/earnings ratio of the S&P 500 index based on expected 2012 earnings was around 10.0 following Monday's selloff, making stocks and the broader stock market look extremely cheap in historical terms.

Market Declines

In numerous updates and newsletters we have discussed how the market behaves over both the short and long run. For example, since 1900 we know the stock market has averaged a 10%-15% peak-to-trough decline each year, while every other year the decline can reach 15%-20%. In other words, although we may not like it, the volatility like we have experienced recently is NORMAL market behavior. And, as we've also noted previously, the annual dips are driven by different factors each time and are unknowable in advance. As a result, the key is to remain rational and focused on the long term during periods such as this. For proof, all you need to do is look back over the last few years. In 2009, for example, the S&P 500 dipped more than 27% from early January through early March, only to finish up 25% for the year. In 2010, the S&P 500 dipped 15% between April and June yet finished up 15% for the year. And this year, in just 11 trading days between July 22 and yesterday's close, the S&P 500 dropped more than 16%. Yet based on history, (and current earnings growth) no one should be surprised to see the market finish up strongly for the year.

So Where Do We Go From Here?

The uncertainty and loss of confidence surrounding the S&P downgrade has generated a significant increase in market volatility, and we expect this volatility will be with us for a while. The downgrade, however, does nothing to impact the fundamentals of the economy or the fundamentals of corporate profitability. Instead, it has impacted the psychology of many investors and for many Americans, it's seen as an embarrassment. Nevertheless, in the longer term, the downgrade could turn out to be a positive. It may finally force our politicians in Washington to confront the serious budgetary issues that we face and fix the problems while they are still eminently fixable. The economy could potentially benefit from the downgrade as well, especially if oil and other commodities can hang on to the steep declines they saw Monday.

One Final Thought

History shows that this country always finds a way to solve its serious economic problems. In fact, looking back to the late 1970s and early 1980s the U.S. faced problems of similar magnitude. Then the elections of the early 1980s served to change the country's course and a boom of unprecedented magnitude ensued. So if there is a silver lining in all of this, perhaps the downgrade will act as a wakeup call and force Washington to get serious about balancing the budget in a sensible fashion. In fact, S&P's rationale for the downgrade specifically mentions the need for a more balanced approach to budget reform, which would include both spending cuts and new revenues. As we have stated numerous times, the Simpson-Bowles plan addresses this issue in an intelligent, bipartisan manner. If nothing else, we hope this event will influence our politicians to reexamine their dysfunctional attempts at budget reform and get serious about fixing the problems that confront us...in a balanced way.

In the meantime, we will use the volatility as an opportunity to rebalance into underpriced assets, as needed. Please do not hesitate to call or e-mail us about any of your natural concerns. Market drops are never fun, and we are here to listen to (and answer) your questions and concerns. Even if we don't hear from you, we will continue proactively managing your portfolio, as we have always done in the past.

- ***Joe & The Gang at KWAG***

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