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Is the Sky Falling?

Global stocks markets tumbled as much as 5% today, and the TSX was not immune to the broad based market sell-off. Investors around the globe appear to have woken up this Monday morning and decided that they were fed up of hearing about sovereign debt problems and so they went out and sold everything.

The decision over the weekend by Standard and Poor to downgrade the US government debt by one notch appears to have been the proverbial straw that broke the camel's back. For the last three months sovereign debt problems have been front and center. Ireland had to nationalize its banks. Greece is technically bankrupt and has only been able to continue to pay its bills thanks to a bailout from the European banks. Portugal and Spain are also in serious difficulty and will likely require a financial aid package, and Italy is taking desperate austerity measures in order to avoid a similar fate. The US government reached their debt ceiling limit and were at risk of default, and the continuous political wrangling in Washington has resulted in only a mediocre deficit reduction plan that most analysts don't believe goes far enough to addressing the debt and deficit problems.

The Standard and Poor's decision to downgrade US debt by one notch, while unprecedented, can hardly be considered as dramatic news. S&P put the US government on a CreditWatch on July 15. Implicit in this notice was a strong possibility that they would lower the US government's debt rating within the next 90 days. So the fact that S&P subsequently followed through should not be causing market panic – most market watchers were well aware that this was a very likely outcome. It is also interesting to note that the US dollar has gained ground today versus a number of other major currencies, and that the interest rate on US debt has not risen. Both of these seem improbable if there were a serious concern that the US government will be challenged to repay their debt over time.

And most of the recent economic data has been neutral or positive. While there is still some concern about a double dip recession, particularly in the US, most analysts put that risk at less than 1 in 3.

So then why has the market reacted in such a negative manner?

Fundamentally we have a crisis of confidence triggered by the sovereign debt problems, and amplified by concern about a possible double dip recession.

The US government did not put forward a credible plan to eliminate their deficit and reduce their debt over time, which creates a lot of uncertainty. This also puts additional focus on the problems faced by other countries with more serious debt and deficit issues, and brings into question the ability of these various governments to deliver on their austerity measures.

It is also plausible that part of today's market decline may have a non-economic explanation. Some of the biggest falls of the last 25 years have been attributable to market dynamics, from program trading in 1987 to the LTCM Hedge Fund crisis in 2000 through August 2007's quant blow-up to May 2010's flash crash. Or we may find in a few days or weeks that someone was a forced seller. We do know that market volume's today were only about 50% of normal market volume – so the explanation may be as simple as all of the buyers were on vacation.

One thing is certain – the sky is not falling. And the markets will recover. This may take a few weeks, or perhaps several months. The market fundamentals remain positive, and we see no reason to believe that the market recovery will not continue in the later part of this year.

Regards,

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