

Thoughts About the Recent Equity Market Selloff



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Global equity markets have sold off sharply over the past two days, while yields on longer-term U.S. Treasuries rallied. Though the Federal Reserve's downbeat assessment of the domestic economy seems to have been the catalyst sellers needed, continued

issues in the euro zone and signs of a weakening global macroeconomic environment also contributed to the flight to safety.

Following its September meeting, the Fed on Wednesday launched a new effort to revive a flagging U.S. economy. Dubbed "operation twist" by the press, this plan involves the purchase of \$400 billion in long-term Treasuries over the next nine months, funded by the sale of short-term debt. In addition, the Fed will resume its purchases of mortgage-backed securities.

While these actions are more or less in line with market expectations, investors foresee

little positive impact on near-term economic growth; given the gridlock in Washington, it's unlikely that fiscal policy will step in to augment the Fed's efforts anytime soon. Meanwhile, the tone of the Fed's post-meeting statement likely had a larger impact on investor sentiment, as the central bank noted that "there are significant downside risks to the economic outlook, including strains in global financial markets".

Of course, the euro crisis has continued to dominate headlines.

- Greece is scrambling to make deeper fiscal spending cuts in an effort to obtain its next tranche of financial aid.
- There is widespread fear that a Greek default would inspire contagion not only to other peripheral European nations but to banks across the continent.
- By agreeing last week to loan much-needed dollars to the ECB and other central banks, which will in turn make these dollars available to financial institutions at low interest rates, the Fed is aiding liquidity in Europe.

Meanwhile, fundamental data released of late have been mostly weak, heightening concerns about a global recession.

- The euro zone manufacturing index dropped below 50 in August, indicating a contraction in activity for the first time since July 2009.
- Credit-rating firm Standard & Poor's announced late Wednesday that it was cutting its long-term ratings on several Italian lenders.
- China's manufacturing index deteriorated, falling to a two-month low.

Despite the difficult current environment, there are a number of potential events that could turn the tide of investor sentiment. These include policy action in Europe (including an ECB rate cut and an expansion of the European Financial Stability Facility), the adoption of strong pro-growth policies in the U.S. and Europe, and investment by Brazil and China into the economies of the developed world.

We continue to believe that a broad, globally diversified portfolio will help investors withstand the current market volatility while also positioning them for potential future growth. ■

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