

We've all had that sinking feeling right after you press the "send" button. You immediately think to yourself, "Wait! Stop! I want to say that differently." Well, that's the way we felt after our last email communication to you. We had correctly predicted the ultimate lifting of the debt ceiling after much theatrics and political saber rattling. However, in the midst of great corporate earnings, strengthening balance sheets, and an economy registering paltry growth—but growth nonetheless—we underestimated the impact of the European debt crisis on our own markets. After all, this wasn't 2008...



US banks are in much better shape than three years ago. They aren't lending as freely as most individuals and commercial borrowers would like, but their balance sheets are much stronger. Most non-bank businesses are sitting on more cash than they know what to do with. Similarly, the balance sheets of individuals on average have also been shored up. Shadow banking activity has largely been shut down so everything happens under the regulators' microscope. Granted, many businesses are keeping their powder dry until they figure out the political landscape, but that's not the same as being braced for a Lehman Brothers *deja vu* moment. In fact earlier in the year, despite our government dysfunction, that was the farthest thing from most economists' minds.

This isn't 2008, but the vivid memory of that meltdown is exactly what underlies the current knee-jerk panic-stricken state of the market. And it is what makes our current problems look like those of a few years ago.

In 2008, the capital markets basically froze. Liquidity was king, and debt was the harbinger of all potentially bad outcomes. Those that wanted to reduce their leverage—whether for a cash cushion or for survival—took pretty painful haircuts on the sales prices they realized to do so. Anything that could be sold to reduce leverage was.

Given the backdrop of our current nascent economic recovery, the new risks our country faces—risks emanating from political rather than financial mistakes—make us that much more vulnerable to the shakiness of Europe. One day earlier this week, the entire investing world was taken aback as the S&P 500 moved four percent (!) in half an hour as a result of a statement from a European leader regarding action they were simply considering. Hadn't planned. Hadn't implemented. Just thinking about it.



Earlier this year, we believed policy makers across the Atlantic had to have learned from our country's mistakes-no one wants to hear the giant sucking sound of an important financial institution going under. We are far too interconnected globally. We thought they were on a path to demonstrating that knowledge.

So, we hit send on our email to you then watched as Europe's leaders came perilously close to repeating our country's blunders through their lack of execution. As we have discussed with many of you, despite having positioned portfolios somewhat cautiously at the second quarter with higher cash levels than normal, we immediately started raising more cash.

Our average client portfolio ended the third quarter with about twice as much cash as it held in early July. Cash really is the simplest and most cost effective hedge. The cash in portfolios didn't keep all other asset classes from taking a dive during the quarter. US stocks were down 14-26% depending on the index, emerging market stocks dropped 26%, high yield debt sank eight percent. Though investment grade corporate bonds managed to eke out a slight gain in the quarter, they spent the last two months of the quarter in decline.

As we sit here, it looks as though EU leaders are significantly closer to agreement on a comprehensive recapitalization plan to keep the EU intact and afloat. Nothing will come easily though with so many disparate national interests to consider so we expect the recent volatility to continue.

Once that hurdle is past, investors will no doubt focus their attention back to our side of the Atlantic and our own fiscal overhaul. As Sir Winston Churchill observed, "The Americans will always do the right thing...after they have exhausted all the alternatives." Until then, we will remain cautious.

Warmest regards,

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