

The Market Finally Corrects

A market correction is defined as a peak to trough slide in excess of 10%. Over the history of U.S. equity markets, corrections have been a relatively common occurrence. They are considered a normal part of a healthy market. However, since the bottom of the Great Recession, we have experienced only one correction in U.S. large company stocks. That correction occurred in the latter half of 2011 when the credit quality of the U.S. was downgraded. It has been four years since the last correction, and statistically, we have been overdue for a downturn.

As markets closed on Friday, several equity indices were close to, if not over, the limit of a technical correction. Fears spread over the weekend, and Monday morning markets opened 4-5% off Friday's close. The Dow Jones Industrial Average (DJIA) fell slightly more than 1,000 points at the open, recovered 850 points, and then closed down short of 600 in volatile trading. The DJIA is off approximately 13% from the year to date high reached in May. The more diverse S&P 500 is down roughly 11% from its year to date high also reached in May.

What is Driving the Current Volatility?

Since the Great Recession, the world has lurched from one crisis to the next (including frequently revisiting prior crises). Throughout these episodes, markets have been relatively resilient, with measures of market volatility generally staying below historical averages and the incidence of corrections below normal. Earnings in the U.S. climbed to record levels, defaults on debt are below historical averages, company balance sheets are relatively strong, and valuations ticked up as each crisis passed without significant impact to companies or markets.

Over the last week, markets have grown concerned about two main factors: the Chinese economy, and the potential action of the Federal Reserve. A third factor, lower oil prices, is also weighing on sentiment. First, investors are worried about the Chinese economy because it has been the primary driver of global GDP growth over the last several years. Throughout recoveries in the modern era, the U.S. has generally contributed the largest percentage to global GDP growth. However, in this most recent recovery, China has been responsible for approximately one-third to one-half of global GDP growth, while the U.S. contributed roughly 17% and Europe and Japan contributed less than 10% each.¹² That economic strength appears to be threatened and investors are questioning the Chinese government's ability to steer the economy through this rough patch.

¹ "A Global Recession May be Brewing in China," *Wall Street Journal*, August 16, 2015

² "China to Flood Economy with Cash as Global Markets Lose Faith," *Wall Street Journal*, August 24, 2015

Here in the U.S., expectations have been growing all year for the first Federal Reserve interest rate hike of the current cycle. In anticipation of this hike, markets have been pricing in tighter policy. However, the Fed has noted in several statements that it would consider the context of global stability, and despite continuing domestic labor market improvement, global stability has certainly deteriorated over the last couple of weeks. This creates additional uncertainty as the market attempts to gauge what the Fed will do at its September policy meeting. Prior to last week's volatility, consensus views suggested a high probability that the Fed would increase rates in September. As of Friday, that probability had fallen to less than 25%.³ The actual policy response may be less important than gaining clarity around the direction of rates. Markets will likely look for some guidance as central bankers come together at their annual policy meeting in Jackson Hole later this week.

The third factor moving markets is the price of oil. Global oil markets have been oversupplied recently as U.S. oil production peaked and OPEC declined to reduce production. There is more oil being produced than the amount needed by the current global economy. As a result, the price of oil has recently slid below \$40 per barrel.⁴ Investors are struggling with the implications of the price of oil as the recent decline may be less a function of current supply and demand levels and more a forecast of slower growth ahead.

Where Do We Go From Here?

The Chinese government has responded to growth concerns by devaluing the Chinese yuan to make Chinese exports more competitive. This was a somewhat unexpected move and actually added to volatility, as it implies some amount of deflation is likely to be imported from China. However, the devaluation is ultimately expected to benefit the Chinese export sector. To prevent a freefall of the yuan, China has used its reserves to intervene in currency markets and stabilize the yuan. In addition, as expected, the government cut the reserve requirement to free up funds for loans.⁵ To some extent, the Chinese intervention has helped government-sponsored companies but has left non-government companies to fend for themselves. The non-standard intervention and favoritism means it remains to be seen if investors regain faith in the Chinese government's ability to steer the economy while continuing to move towards an open and freer economy.

Notwithstanding China, the global economy is continuing to grow, though admittedly slowly. Even China is expected to grow. The question is whether it will grow at 6% or 7%. Global central banks remain accommodative and are likely to remain accommodative. Even if the Fed does decide to start raising interest rates, a federal funds rate at 0.50% and a 10-year Treasury rate at 2.00% remain low and accommodative by historical standards. Europe and Japan have been growing at a faster pace recently, and only a couple of weeks ago it appeared that the U.S. economy likely had recovered to a point where the Fed could start to raise interest rates. Company balance sheets are strong and operations are lean with refinanced debt reducing

³ CME Group Implied Fed Funds Probability

⁴ West Texas Intermediate spot price, intraday 8/24/2015

⁵ "China to Flood Economy with Cash as Global Markets Lose Faith," *Wall Street Journal*, August 24, 2015

interest expense over the last several years and bulk maturities pushed into the future. In addition, the U.S. consumer has picked up spending since the first quarter and the service economy is growing at the fastest pace of the recovery. The concerns in China have not significantly impacted the outlook for the domestic economy. As stated above, we may see some policy guidance from the Fed at the Jackson Hole meeting, and then investor focus will turn to the August labor market report to see if hiring has slowed because of global turmoil.

Generally speaking, market corrections tend to be healthy by helping to reset excesses that build through bull market periods. Market valuations had risen above longer term averages and the current drawdown will bring those valuations closer to the norm. In addition, in the last 40 years, recessionary periods have followed periods of significant Fed tightening after higher levels of inflation or excess demand (overheated economy), and as noted by Oppenheimer Funds, neither of those conditions appear present right now or likely in the near term.⁶ There may be other reasons for optimism. As noted by MFS, the wholesale drop in commodity prices – including oil, copper, iron ore, etc. – may suggest a future pickup in profits for global companies.⁷

In the meantime, despite recent losses, international equities generally continue to hold an advantage over U.S. equities on a year to date basis. Fixed income has been more resilient than equities, with higher quality securities benefiting from a flight to quality. In short, diversified portfolios are generally holding up slightly better than U.S. markets.

Markets may reverse to recapture some of the losses of the last few days, or markets may continue to slide until investors are comfortable that price levels reflect the amount of uncertainty present in the outlook. In the short run, predicting market turning points is nearly impossible. We remain more confident in the long run prospects of global capital markets. For this reason, we continue to recommend holding a diversified portfolio of global stocks and bonds that is rebalanced to manage risk. However, if you are concerned about recent market movements, we recommend contacting your HD Vest Advisor to determine how market changes impact your long term goals.

⁶ "Is This a Correction or the End of the Bull Cycle," OppenheimerFunds, August 23, 2015

⁷ "Thinking Twice About Profits, Currency and Opportunity Risk," MFS Strategist Corner, August 2015

Disclosures:

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The Dow Jones Industrial Average (DJIA) is a price weighted index of 30 U.S blue-chip companies. The DJIA covers all industries with the exception of transportation and utilities.

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