

Perspective

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# Market Corrections, the Economy, and S&P's Downgrade

Recent weeks have presented investors with a unique set of challenges. During times like these, we are wise to view events in their proper context. This paper is an effort to provide you with clarity and perspective.



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# Our Current Perspective on Market Corrections, the Economy, and S&P's Downgrade

As you are surely aware, following Tuesday's debt ceiling compromise, attention rapidly shifted to whether the government has what it takes to solve its budget problems. Add to this the fact that Italy is now in the forefront of debt problems in Europe and anemic economic news has been pushing investor sentiment downward, and you have a near-perfect recipe for a stock market correction. And a correction – defined as a 10% drop from recent highs – is exactly what we experienced last week as major indexes erased their gains for the year.<sup>1</sup> At times like this, we are wise to view events in the proper context and avoid letting brief periods of negativity derail our long-term strategies.

## ❖ **Market corrections are not unusual events.**

- From the market lows of July 2010 to the highs of April 2011, the S&P 500 was up over 26% without experiencing a correction. To put that 26% run-up in perspective, the best 20-year time period for the stock market was 1948-1968, and the market only returned an average of 8.4% annually during that period. This illustrates that we were overdue for a correction.<sup>2</sup>
- If you look at the performance of the S&P 500 for 2010, you will see that there was a 0% return through September 21<sup>st</sup> due to a 15% peak-to-trough decline during the summer months. Despite that correction, the market went on to return a respectable 15% for the year. Remarkably, the whole annual return of approximately 15% came during the final 14 weeks of the year, demonstrating how quickly markets can drop, and then recover.<sup>3</sup>
- We saw losses of over 8% within 10 days on two separate occasions just last summer, but as previously mentioned, the year still ended up significantly.<sup>4</sup>
- If you look at a table of the 10 worst days in the equity markets since 1987, you will see that the 4.3% drop we saw on the Dow last Thursday doesn't even come close to the 10 worst days which averaged drops of 8.86%.<sup>5</sup>

There have been many U.S. equity market downturns over time, varying in length and severity. The most severe downturn marked the start of the Great Depression, where stocks lost over 80% of their value. More recently, stocks lost 50.9% of their value during the 2007-2009 bear market. The recovery period following the Great depression took over 12 years, while we are less than two and a half years into the current recovery, and we don't know how long it will last. During recovery periods, stocks are prone to sudden declines in value. Unexpected drops in the market can be painful, but they are part of the healing process.<sup>6</sup>

## ❖ The economic data doesn't portend another recession.

- *Corporate earnings are rising rapidly.* With only 80 companies left to report, S&P 500 earnings are up 20% over last year.<sup>7</sup>
- *The jobs picture is improving.* Initial jobless claims are at 400,000, down from 478,000 at the end of April,<sup>8</sup> and unemployment fell to 9.1 from 9.2 in July.<sup>9</sup> In addition, the ADP employment report showed 114,000 new private sector jobs in July, which was the 18<sup>th</sup> consecutive monthly gain.<sup>10</sup>
- *Americans are spending money.* Car and truck sales were up 6.9% and chain-store retail sales were up 4.6% in July. Altogether, retail sales appear to have increased by about 0.7% in July.<sup>11</sup>
- *Manufacturing is consistent.* The ISM manufacturing index was 50.9 in July, which marks the 24<sup>th</sup> consecutive month with a reading above 50. A reading above 50 is considered to be in line with 2% or more GDP growth.

## ❖ Where do we stand?

When you combine strong corporate earnings with an improving jobs picture, increasing consumer spending, and consistent manufacturing, it is easy to see that, unlike 2008, we are not in the midst of a financial crisis. The entire U.S. banking system is not on the edge of default. Markets are functioning, governments are borrowing, and volatility in the markets is relatively tame compared with what we saw beginning in 2007. While things may be momentarily slowing, we are not experiencing a meltdown.

In the grand scheme of things, the market moves of last week are really not out of the ordinary. Even a one-day selloff similar to what we saw on Thursday is not that unusual. In our assessment, the turmoil of recent weeks reflects the fact that fear is still dominating investor sentiment. Highlighting this, Wall Street's "fear" gauge – the VIX – jumped almost 36% on Thursday, and eventually ended Friday with a reading of 32.05. Anything above 30 indicates a heightened sense of fear.<sup>12</sup> What are people afraid of? While there are several factors that could be cited, we believe debt problems domestically and abroad are in the forefront.

## ❖ **What about the European Debt Crisis?**

While it is true that European countries have spent themselves into a corner, correcting this mistake will be good for long term growth, not bad. While some financial institutions may face losses in the process, the minimal level of European exposure U.S. banks have, makes them well equipped to face this challenge. Our research tells us that the odds of significant damage to the U.S. economic system resulting from European debt failures are very low.

## ❖ **Should you be concerned about the S&P downgrade of the U.S. credit rating?**

While the full implications of the downgrade are not clear yet, we do have some initial observations we would like to share with you.

- Although S&P downgraded the nation's bond rating from AAA to AA+, Moodys Investors Service took the opportunity to reaffirm the United State's AAA rating. The U.S. now has a split rating from the two largest ratings agencies. The third-largest ratings agency, FitchRatings, also agreed with Moody's AAA rating.<sup>13</sup>
- In confirming the AAA rating, Moody's recognized that the budget compromise is a first step toward achieving long-term fiscal improvement. The legislation passed on August 2<sup>nd</sup> calls for \$917 billion in specific spending cuts over the next decade and established a congressional committee charged with making recommendations for achieving a further \$1.5 trillion in deficit reduction over the same time period.<sup>14</sup>
- This downgrade of the U.S. was based, not on an ability to pay bond-holders, but on political mayhem over the debt deal and the potential for further controversy in the years ahead. The Fed will still apply a 0% risk-weighted capital requirement on Treasury debt.<sup>15</sup>

This move by the S&P definitely strikes a nerve. America's credit rating has never been downgraded before and people don't know what to expect. Even so, if it helps the U.S. get more serious about fiscal responsibility, it could turn out to be a very positive development.

### **In conclusion:**

Successful investing is a long term project undertaken with risk and uncertainty. Equity markets do not move in a straight line, and neither do economic recoveries. We wish we had the ability to trade every move, but that just isn't possible.

Another thing we know is that fundamentals suggest the market is undervalued and getting more so as it drops. If we decide to sell out when the market is at a low point and buy back in when we see an upturn, we could cause our clients to experience unnecessary losses. Despite being

painful, corrections like this historically run their course and then come to an end. We do not think that now is the time to take drastic action.

We encourage you to tune out the media fanfare and remember that we have been through much worse. Please try to see recent events in context and do not allow them to disrupt your long term financial objectives.

As always, we are here to provide you with clarity, perspective, and support during challenging times like these. Thank you for the confidence you have placed in our abilities. We consider it an honor and a privilege to be good stewards of the assets you have entrusted to our care.

Warm Regards,



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