MANAGED ASSET PORTFOLIOS

Global Market Sell-Off:
Why We Are Not Panicking

As we left work last week, the employees of MAP were all collectively asking the same question: Was last week's market decline the start of something more significant? As much as it was impossible to answer this question with any sort of certainty, there was one prediction we were more confident in making – the financial media will do their best to dramatize the decline. We were not disappointed. Below you will find a few headlines that made their way to the front pages of some of the news sources popular with our clients:

"Stock Plunge Picks Up Speed" – *WSJ* 08-22 - 08-23- 2015 – Front Page

"Dow Plunges 1,000 Points; off 6% on Week" – *Barron's* 08-24-2015 – Front Page

"What To Do When The Market Falls" – *Chicago Tribune* 08-23-2015 – Front Page

"Global Stocks Suffer Sell-Off as Fears Intensify Over Chinese Slowdown" - *FT* 08-22-2015 – Front Page

One of our personally favorite articles was found on page B1 of this weekend's *Wall Street Journal* titled: "What Investors Shouldn't Do Now". What was its first piece of advice? Ignore the News. We find it remarkably ironic that the author recommends its readers ignore the newspaper.

Even without the help of fear perpetuated by the media, we know stock market (pick whatever verb best suites your personality) plunges, corrections, routs, sell-offs, volatility, and/or declines are painful events. Human nature dictates that we must compare last week's (and today's) stock market activity directly to past financial crises and accordingly resurrect the feelings of fear and anxiety that accompanied those stressful periods of time. For example, any trouble in today's stock market makes us feel like 2008 was yesterday.

With that being said, let's add an historical context to last week's market. Friday's sell off marked the largest one day decline for the major averages since 2011, when S&P lowered its rating on U.S. government debt. After these declines, the Dow Jones Industrials are off 10.1% from the record highs reached a mere 3 months ago; this popular benchmark is now in officially in "correction territory" – the first time that this has occurred since 2011. The NASDAQ Composite is off 9.83% from its peak achieved just over a month ago. From their May peaks, the S&P 500 is down 7.5% while (from a global perspective) the MSCI ACWI is off 10.18%.

We do not view this to be the beginning of a crash or bear market, but rather a correction within the confines of a multi-year bull market. Let's look at this market from a longer term perspective. Since the end of World War II, there have been 27 stock market corrections of 10% or more and 12 full-blown bear markets, whereby the markets fell more than 20%. During the 27 corrections, the average decline has been 13.3% and has lasted approximately three months. From the beginning of the great bull market in 1982 through 1987, there was only one 10%+ correction. From 1987's crash up until the bursting of the dot com bubble, there were only two corrections. Since the stock market bottom in March of 2009, there have been two corrections.

In the spring of 2010, the S&P 500 fell approximately 16% over 69 trading days. The summer correction of 2011 lasted 154 days and came close to becoming a bear market, falling nearly 20%. We should note that in the spring of 2012, there was a decline of 9.9%, but since it did not breach the 10% level, it was not technically considered a "correction".

Despite the feelings of similarity, it is important to recognize that 2015 is a much different market than any market we have seen in recent history. We have noted in several of our recent market updates and presentations that recent stock market performance was overly dependent upon a few high profile growth stocks. Highflying performances of Facebook, Netflix, Amazon, Tesla, and several biotech stocks were all masking the flat performance of the value stocks we prefer to focus upon. In fact, the valuation difference between growth and value is the widest it has been since the internet bubble that ended in March 2000.

A second difference of this market versus past stock markets is the Federal Reserve's disposition on interest rates. In 2007, the ten year Treasury bond was hovering around 5%, a thirty year mortgage was a good deal at 7%, and (as of December 31, 2007) the Fed Funds rate was 5.25%. Back then, the Federal Reserve had the flexibility of lowering interest rates to mitigate the economic effects of a stock market decline. In 2008, they took full advantage of this flexibility and lowered rates aggressively. By the end of 2008, the Fed Funds target rate was essentially 0% - the level where it remains today. Unlike in 2007 (or any period before it), the Fed does not have that same flexibility today as it did in the past and would have to resort to extraordinary measures (think QE here) if they needed to force yields lower than their current paltry rates. To further show how much things have changed, recent minutes of the Fed meetings indicate the Fed is looking to raise rates - something they have not done since 2006. To put this timeframe in context…in 2006 Barack Obama was in the U.S. Senate, Twitter put out its first tweet and there were rumors that Apple was going to introduce an iPhone. In as much as the Fed would like to raise rates, we believe their hands are tied. The U.S. economy is far from strong. While headline unemployment numbers are encouraging, the fact is that the majority of new job creation is in the lower paying service sector and wage increases are virtually nonexistent. Furthermore, as investors speculated on the Fed increasing rates, the U.S. dollar staged a strong rally during the second half of 2014 and the first quarter of 2015. The surging dollar hurt virtually all companies that export their goods. In fact, during the first quarter of this year, 349 companies out of the S&P 500 said the strong dollar was a headwind for the their revenues and earnings.

Any rate hikes that take place in the short term would likely push the dollar higher, hurt more domestic companies that export their goods, which would subsequently cause layoffs and possibly induce another recession. As such, we do not believe the Fed will hike rates anytime soon.

The markets are likely to remain volatile until the Fed lays out its interest rate agenda. Words from the Fed that interest rate hikes are on hold, would likely cause meaningful rally for global equities. We think the declines in global markets over the past few weeks, combined with an uncertain domestic economic outlook will force the Fed to delay interest rate hikes. While we believe rates will have an upward bias, we believe when the Fed does move it will be in very small steps, so they will not interfere with the frail economic recovery. We suspect interest rate hikes will be delayed until the middle of 2016.

Finally, we would be remiss to conclude this note without mentioning China. We are more concerned about the Chinese economy than its stock market. The Chinese stock market was bid up to bubble like valuations, and now the bubble is bursting. At the peak of the Chinese market, two months ago, the average tech stock was selling at 250 times earnings. For a perspective, the average NASDAQ technology stock traded at 150 times earnings in 1999 at the peak of the dot com bubble. Even with the recent pullback, we view Chinese stocks as overpriced and substantial downside risk remains. While it may make for interesting soundbites on CNBC, we do not believe the deflating of the stock market bubble in Shanghai will have any lasting ramifications in the U.S. As many of our clients will recall, we have not owned Chinese equities because we believe their business practices and accounting principles to be too opaque to effectively analyze.
The Chinese economy does merit watching as it has clearly helped lead the global recovery since the 2008 recession. Chinese policy makers have targeted 7% GDP growth, but it appears that they are falling well shy of targets. This is weighing on the price of commodities across the board. Base metals, energy, etc. are now trading at prices last witnessed in 2009, in the midst of the economic recession. The Chinese government has taken steps to try to boost their stock market and economy, but to no avail. We believe the Chinese government will take further actions to stimulate its economy, including further currency devaluations.

As we trust our clients understand by now, we believe in investing in companies that are considered value stocks. We have shunned and will continue to shun the risky, high flying stocks that require strong economic tailwinds to perform well. We prefer to focus our efforts on the under-the-radar value companies that have treated us so well for the last 14 years. You will not likely be reading these names in tomorrow's newspaper – they are simply not exciting enough to write about. Nor are you likely to see their prices appreciate wildly if the stock market were to rapidly gain back the 6% it lost last week. You may, however, find yourself using their products in your everyday life. You may further notice their stock prices slowly working their way higher as the press breathlessly tries to get you to focus on the crisis de jour.

In closing, while market declines are never fun, they are a part of investing. At this point, we have no intentions to sway from our investment strategy, and as such, we remain steadfast. We believe our clients' portfolios are well-positioned to weather the storm and, furthermore, to participate when sentiment turns for the better.

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