A Commentary on the Correction

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Global stocks[i] had plummeted 13.9% year-to-date as of the close of market on August 8th although they have since bounced back somewhat. The speed of this decline has staggered many investors, exacerbating a sense of anxiety that has not fully dissipated since the market crash. These emotions are understandable but before acting in haste, investors need to consider the following:

- Market corrections occur frequently. Since 1950, there have been 37 market[ii] declines of 10% or greater, a frequency of nearly one every twenty months.

- Most market corrections are not accompanied by recessions. In 27 of the 37 corrections – nearly three quarters - no recession ensued. The stock market frequently forecasts economic downturns that do not occur.

- Many corrections occur quickly. Just over 40% of corrections played out in 75 days or less. In the summer of 1998, for example, the market dropped 19.3% over 46 days in response to the Russian bond default crisis.

- Market corrections are always painful. The average decline for all 37 corrections was 19.7%. This decline has yet to hit this average.

- A strong recovery from market corrections is the norm. In 34 of the 37 corrections, the market was up 12 months later by an average of 26.8%.

No one can predict the path of the global economy with certainty. Unquestionably risks have been elevated by ongoing sovereign debt issues and indications of slower global growth. However, in our opinion, current economic statistics suggest that slower growth - *not* a double-digit recession - is still the most likely scenario. In this regard, the following facts should be noted.

- The International Monetary Fund reported on June 17th that the global economy expanded at an annualized real rate of 4.3% in the first quarter of 2011, notwithstanding weaker growth in the U.S. and the devastating effect of the tsunami on Japan. Growth was particularly strong in the emerging and developing economies while Europe also surprised to the upside.

- On August 3rd, the JPMorgan Global Manufacturing & Services PMI, a composite indicator of economic expansion was up reporting that "the global economy expanded at a slightly quicker pace in July, as faster growth of services business activity offset a weaker increase in manufacturing production. At 52.6, up from 52.3 in June, the JPMorgan Global All-Industry Output Index remained above the 50.0 mark, signalling expansion, for the twenty-fourth consecutive month."[iii]

- Economic slowdowns in the midst of business cycles are normal. Companies frequently slow the pace of inventory additions after the initial surge at the start of the cycle. Growth decelerated for several quarters in 1986, 1995 and 2006 in the last three business cycles without lapsing into a recession.

- The falling interest rates and commodity prices, especially oil, which accompany market corrections, are inherently stimulative. Declining mortgage rates in the U.S. will make home ownership more affordable and refinancings will either increase consumption or accelerate the rate of deleveraging. Lower oil prices will translate into lower gas prices, immediately lifting discretionary cash flow. Lower commodity prices will help ease the inflationary challenges facing the emerging economies.

The current market correction is also occurring at a time of strong corporate balance sheets and profitability. Moody's recently reported that at the end of 2010, U.S. nonfinancial companies held a total of $1.24 trillion in cash. Standard & Poor's reports the profits of the companies in the S&P 500 in the second quarter of 2011 are currently estimated to have grown 11% over the same quarter in 2010. Over 70% of companies that have reported their second quarter results beat their estimates.

Stock valuations on both an absolute and relative basis are increasingly attractive. Based on Standard & Poor's estimate of reported profits over the 12 months ended June 30, 2011, the price-earnings ratio as of August 8th was 13.4, 15% below the long-term average of 15.8. This translates into an earnings yield of 7.5%, far in excess of the modest 2.4% yield offered by a ten-year Treasury note.

On a sovereign debt front, the downgrade of *long-term* U.S. debt to 'AA+' from 'AAA' by Standard & Poor's has not had a material impact on credit markets. Importantly, the S&P reaffirmed the top rating of 'A-1+' on U.S. *short-term* debt. Also, the rationale behind their downgrade was the political impasse in the U.S. that thwarted a balanced solution to deficit reduction as opposed to either solvency or liquidity issues. The elections in 2012 will offer an opportunity to resolve this gridlock.

The European debt crisis is of greater concern since solvency worries concerning Italy and Spain lie at the heart of the problem. However, rising government yields as well as the market correction has triggered a speedy response. Both Italy and Spain have announced additional austerity measures as well as long overdue structural reforms which should accelerate their move to balanced budgets.

The European Central Bank (ECB) has also commenced buying Italian and Spanish government bonds with the immediate impact of reducing borrowing costs for both countries. Since the ECB is ultimately funded by the eurozone countries, this indirectly extends the support of the stronger European countries such as Germany and France to weaker nations; a vital move in reducing the probability of sovereign debt defaults and the consequent contagion.

On a monetary front, expansionary policy in the developed world has lowered short-term rates to rock bottom levels for an extended period. Even within most developing countries, recent rate increases leave policy generally accommodative for growth. Continued economic weakness is likely to lead to additional quantitative easing as well as lower interest rates in Europe. Most importantly, money supply growth in the U.S. and Europe remains solidly positive as central banks ensure that the contraction of the money supply, the hallmark of the Great Depression, is avoided.

In conclusion, the U.S. downgrade, resurgent sovereign debt concerns in Europe and a political leadership vacuum in concert with reduced economic momentum triggered a reappraisal of global growth prospects and a sharp sell-off in markets. Downside risks are certainly elevated as business and investor confidence have been shaken by the events of the past few weeks so some investors may want to trim their risk exposure. Investors with customized, diversified long-term strategies should ensure their portfolios are in line with their target asset mixes and stay on course.

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[i] MSCI All Country World Price Index
[ii] Based on S&P 500 Price Index and excludes the most recent decline
[iii] Institute for Supply Management, http://www.ism.ws/ISMReport/content.cfm?ItemNumber=21776