

## Correction or Crash?

*Market Commentary by Randy McGill, Branch Manager and Mark Rojek, JD, CPA, Financial Advisor – August 9<sup>th</sup>, 2011*

Equity markets in the U.S. and around the globe tumbled yesterday, August 8<sup>th</sup>, as investor fears brought the selling of equities to a crescendo high by the close of business. Following a week in which the S&P 500, an index of 500 of the largest U.S. stocks, declined 7.2% and saw the ratings agency Standard & Poors downgrade U.S. Treasury securities for the first time in history, the market on Monday fell into a free-fall, sinking an additional 6.2% in a single day. This decline represents the worst one-day stock market decline since December 2008 and decidedly slammed the brakes on any positive momentum the markets had generated in the first half of the year.

A combination of factors contributed to this large-scale sell-off. First, the nagging issue of European sovereign debt has generated new concerns, now spreading to countries including Italy and Spain. Secondly, the seriousness of our own nation's debt burden and the perceived inability of our leadership to craft a viable deficit reduction plan have led to the unprecedented credit-rating downgrade mentioned above. And finally, and perhaps most importantly, the fear of a worldwide, so-called "double-dip" recession, which would deteriorate corporate earnings and shareholder value has driven stock investors to sell, sell, sell in recent days.

In contrast to the confusing barrage of media coverage and speculation, we would like to offer what we hope is a rational perspective on the direction of the financial markets. First, as experienced investors well know, the stock market never simply moves in a straight line up or down. Even in 2009 and 2010, years during which the S&P 500 rose 26.5% and 15.1% respectively, the index plunged to intra-year corrections of -25.1% and -16.0% before those gains were recorded. In fact, according to Paul Quinsee, CIO - US Core and Value Equity, JP Morgan, the average intra-year decline in the S&P 500 since 1980 has been -14%. In light of these facts, this year's -18.3% decline (intra-day peak to trough through yesterday) may simply be a "normal correction" that will, in time, "correct" itself.

If we enter a new global recession, however, then the argument that recent market activity represents a simple correction may not be valid; and there is evidence to support this view. Indeed, a recent string of economic data has suggested that the economic recovery is proceeding at a very slow rate. Perhaps most telling, U.S. GDP growth has been revised downward to an anemic .4% in the first quarter of 2011. Even the surprisingly positive July job growth numbers published last week, which included upward revisions for May and June, have been discounted by the stock market. Indeed, market sentiment remains stubbornly bearish, leading some to speculate that the current outlook for stocks is similar to 2008.

For many investors, the very real pain experienced during the fall of 2008 and the first two months of 2009 remains an all too present memory. During this period that triggered what we like to call the Great Recession, credit markets ceased to function, corporate earnings deteriorated almost overnight, and large financial institutions like Lehman Brothers fell to the cruel sword of bankruptcy. The result? Financial asset values plummeted as investors fled to safety; and U.S. Treasuries became the only asset class that grew in value.

So, is history repeating itself in 2011? We don't think so. The toxic combination of economic factors in place in September 2008 has improved dramatically since then. To begin with, and according to economists at John Hancock, homeowner equity has declined more than 50% since that time, creating more realistic real asset values. In addition, credit default risk has declined dramatically. Our nation's financial institutions have strengthened their capital ratios and de-leveraged away from risky assets. Indeed, our corporations' collective balance sheets are now remarkably strong, with \$1.6 trillion in cash available for investment as of April 1<sup>st</sup>, 2011 according to the Bureau of Economic Analysis. And American consumers have improved their personal balance sheets as well by paying down debt, focusing on saving and consuming in a more responsible manner. Clearly there are headwinds that have derailed strong growth: surging energy prices, the public debt burden, and naggingly high unemployment – all of which have

acted as drags on consumer spending. Nonetheless, our view is that current economic indicators, and especially the recent decline in oil prices, point to continued slow growth, not negative growth (recession).

So where does that leave investors? First, our investing clients should understand that stock market performance does not necessarily dictate portfolio performance. Secondly, our clients should understand that in lieu of attempting to “time the market”, our investment approach incorporates several important tools to help manage risk: exposure to fixed income securities, which typically provide stability and income during periods of equity declines, exposure to specialty funds including REITS, natural resources and precious metals stocks, some of which may buck the trend of a decline in traditional equities, and finally, exposure to managed short-equity as a direct hedge to our long equity holdings, i.e., positions designed (although not guaranteed) to rise in value during equity market downturns. Because of this, we have been successful at mitigating a significant portion of the losses associated with the sharp downturns of early 2009, the second quarter of 2010 and so far in the third quarter of 2011. In other words, our clients should not assume that their portfolios are performing in lockstep with the market; indeed, they are not.

That is not to say that declines in portfolio values have been mitigated entirely. Clearly our domestic and international equity holdings have suffered in recent weeks. Nonetheless, our fixed income positions and especially our managed short equity positions have rallied in value during these tumultuous times. The end result is that our clients have not and are not expected to experience deterioration in their portfolio values equal to that of the stock market. As our clients know, this is a fundamental tenet of our approach to asset management.

So what is most important here? It is imperative that our clients, with the help of their advisors, continue to align the inherent risk of their investments with their personal risk tolerance. Indeed, each individual investor must arrive at this fundamental, strategic decision based on his or her own unique set of financial circumstances. And, if circumstances or tolerances for risk change, then portfolios may require adjustment. We also recommend that our clients segment their view of portfolio performance, assigning more weight in the short-term to the performance of the fixed income portion of their portfolios, while taking a longer-term view of the performance of the equity or higher-growth portion.

Finally, we understand that market conditions like we’ve experienced this week may cause every investor to reassess his or her tolerance for risk. If you feel that you would like to discuss your personal risk profile and/or portfolio performance, please call us. Our entire advisory staff stands ready to address your concerns.

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