

Correction? Is it Upon Us?

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2011 Outlook

GDP GROWTH:
3.2%

UNEMPLOYMENT:
9.0%

INFLATION:
1.75%

FED FUNDS RATE:
0.35%

In mid-January, we were not surprised by the downside shifts in stock prices, and we would likewise not be surprised to see further deterioration in stock values. In late September, we became more positive towards the U.S. equity market. The S&P 500 Index has climbed more than 15 percent in value as of March 10. On an annualized basis, this represents an annual return of more than 36 percent. Over the long-term, stock prices have risen roughly seven percent annually. To say we are due for a slow-down in this bull march is probably an understatement. The real question that needs to be asked centers on the catalysts behind the downside move in stock prices. Identifying the catalysts may give us a hint as to the durability of this move and the potential magnitude of this shift, if indeed a shift is occurring.

First, some definitions are in order. What is the meaning of a *bear* market? According to the Dow Theory, a price move of more than 20 percent represents a material change in direction in prices (Bull-to-Bear, or Bear-to-Bull). That type of change, in some quarters, would be called primary in nature. A price change of five-to-20 percent is considered by most market participants a *correction*. In our opinion, anything less than a five percent change in price should be considered *noise*, or not meaningful.

A primary change in stock prices is usually accompanied or forerun by a significant change in Federal Reserve monetary policy (such as a raising or lowering of interest rates or a contraction in growth rate of money supply). Additionally, a primary change in the overall direction of asset values tends to be associated with a start to the end of an economic contraction, or recession. Lastly, the start of a new primary bear market is usually accompanied by widespread giddiness towards stock values. We would suggest none of these macro factors are currently in play.

A correction in stock prices can occur for any number of reasons – from a surprise in earnings momentum, to an unexpected shift in interest rates, to news on commodity prices (oil, for example), to political shifts creating troubles within the banking system (like the situation in Greece). If the stock price shift has legs to it, we believe this is the type of environment which we may currently face. We would not be surprised to see stock prices decline by five-to-20 percent during the next few months. Why is this the case?

The world's investors are currently wrestling with an issue of economic momentum, asking how rapidly and from where is the world's economy growing. China's growth rate is contracting. Unemployment remains a problem in much of the developed world. Greece is back in the news with three-year government interest rates above 17 percent. Tensions within the Middle East/North Africa countries continue to escalate.

Oil and gasoline prices are rising, which may impact U.S. consumption patterns. It is an understatement to say there are justifications for the stock market to cool.

In January, we suggested that "risks appear to be rising for at least a temporary setback in stock prices . . . we would treat weakness in the market as a short-term, but perhaps worrying trend." We stand by that statement.

How Far Down?

A correction phase is upon us, and we may need to ask: "How far is the market going to correct during this phase?" Of course, we do not know the answer to this question, but looking back since the lows experienced in March of 2009, the market has experienced three separate corrections. In June and July of 2009, the market corrected by seven percent. In the first two months of 2010, the market corrected by eight percent. And finally from April-to-July 2010, the market corrected by 16 percent. The average of all three of these corrections has been -10.3 percent. This data may serve as an example of what may occur if the market corrects again.

Final Word

We are concerned about all of the tensions the world is currently facing. Political, banking and economic tensions abound. The environment may be ripe for stock values, at least temporarily, to struggle. However, we stand by our view that the elements which normally presage a significant (more than 20 percent) decline in equity markets currently do not appear to be present.



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