Brad Campbell, CLU, ChFC, MStax, CFP®, CFA®
Executive VP | Chief Investment Officer

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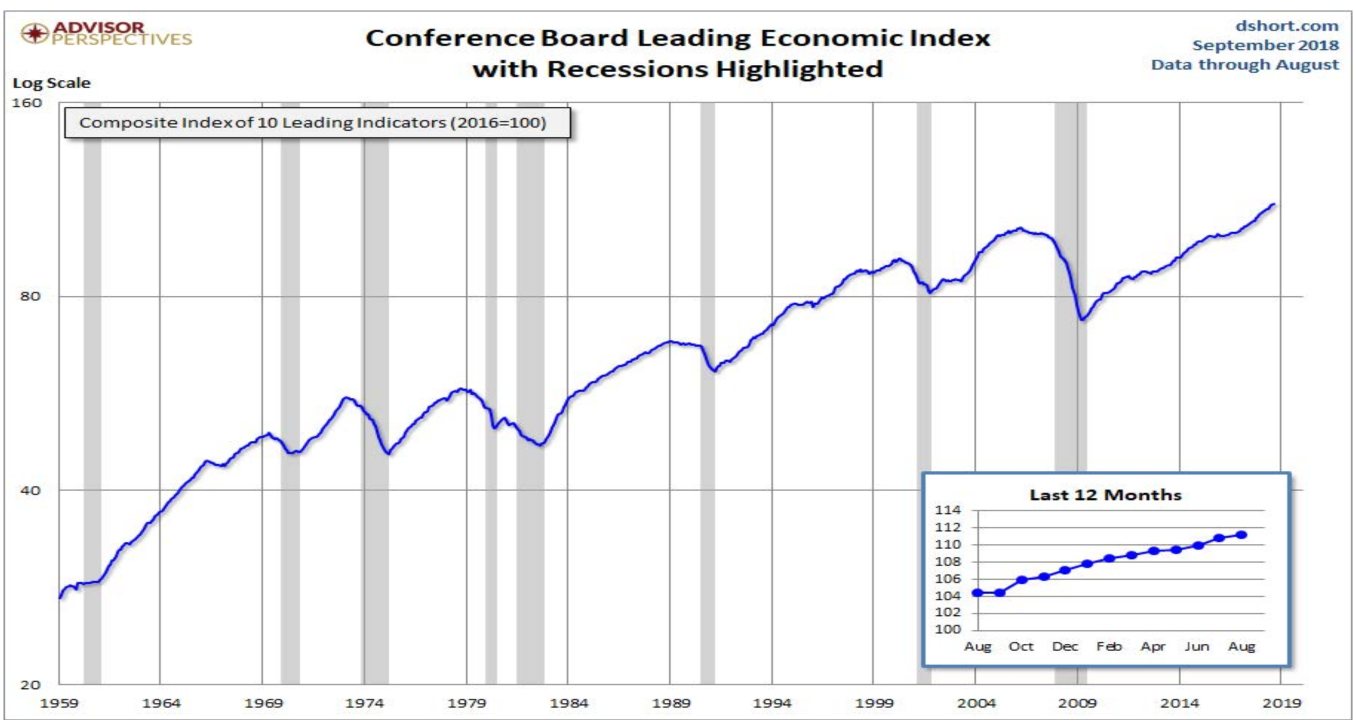
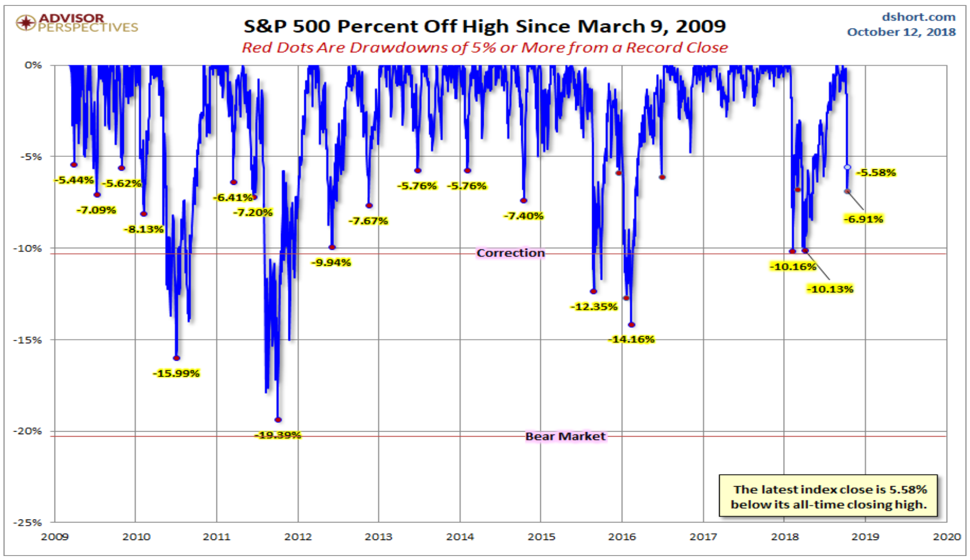
Does Anyone Remember What A Correction Looks Like?

Technically, a market correction is defined as a decline of at least 10% off the last high in stock prices. Despite a six-day losing streak through last Thursday, the market is still shy of correction territory using the S&P 500 Index as a proxy. As of that date, the S&P 500 closed down a total of 6.9% from its previous high, although the technology-heavy NASDAQ Index and Russell 2000 small cap index were down more than 10%. Markets rebounded slightly Friday but we may experience more turbulence as markets find their footing at current levels, or possibly lower if selling pressure continues.

It is important to note that a "correction" is very normal market behavior that occurs during rising markets. Contrast this to an economic recession that causes most major market declines in excess of 20%. If we look at the available data, there is no reason to believe the selloff across global markets is due to an economic slowdown, at least so far. One of our favorite indicators is the Leading Economic Index (LEI), which has a good track record of signaling economic slowdowns. The chart below of the LEI has data through August and clearly has not started to show the risk of a recession in the near future.



With the current pullback creating some stress for investors, it is important to try to separate what is a normal correction from what will eventually be the next bear market for stocks (a price drop in excess of 20%). The chart below illustrates market corrections in the post-2008 era. There have been several price corrections during the recovery from the 2008 - 2009 bear market and this one is still minor in the scheme of things.



One of the dynamics we thought important to call your attention to is the presence of automated trading in today's markets. Most days the amount of computer driven trading is not noticeable. However, when larger, short-term market movements occur certain "triggers" cause large trades to be placed into the market. Last Thursday afternoon, a large volume of selling in the S&P 500 ETF, "SPY", hit the market. This is known as a "program trade". Program trades are often initiated when a major market average breaches key levels typically defined by moving averages of the index level. In this case, the trades were triggered during the last 90 minutes of trading when the index broke the 50-day and 200 -day moving averages. These program trades increased volume and volatility, making the sell-off worse. In the chart of SPY below, you can see the two moving averages referenced above circled as well as the very high volume of trading.

S&P 500 ETF (SPY) Year to Date 2018 Through Last Thursday's Market Close

Source: Yahoo Finance

What triggered the selloff?

The stock and bond markets compete for investor capital. With the Federal Reserve currently raising short-term interest rates, U.S. Treasury Bond yields have risen to post-2008 highs. This results in several dynamics. First, with higher yields on risk-free assets, the potential returns on highly priced riskier assets, like stocks, look less attractive. Take the 3M Company, Inc. (MMM) with a dividend yield of 2.60% as an example. If the yield on a risk-free U.S. Treasury bond is at 3.20% (see chart below) investors may choose bonds over stocks, especially if they are concerned about other economic factors. Of course, MMM may offer more than just a dividend yield over the long-run as stocks usually appreciate in value while treasury bonds offer just the current income.

Second, shares in corporations are generally valued by estimates or opinions on future profits produced by the company's operations. If the risk-free rate of return rises as treasury yields increase, it tends to depress the value of riskier assets at some point.

The third dynamic at play is the continued increase in the value of the dollar versus international currencies. The dollar has gained strength for two reasons; rising yields on treasury bonds have started to attract capital and the strength of the U.S. economy (see chart below) relative to other international economies has caused capital to flow into the U.S. market. This dynamic causes U.S. investment seekers to exchange their home currency for dollars to complete investment transactions. The rise in the value of dollar hurts the profits of companies who derive large amounts of revenue in foreign currency and must then translate it back to dollars.

In addition, the global trade battle continues to drag on with new tariffs imposed seemingly every week. Many U.S. based companies have warned the tariffs are hurting profit opportunities and may cause lay-offs of a portion of their workforce.

10 Year U.S. Treasury Bond Yield

Conclusion

We consider the recent fluctuations as a normal event in a late-cycle bull market uptrend. We anticipate continued bouts of volatility as we approach the next economic recession and associated bear market, but think that may still be a ways off in the future with economic growth still remaining strong

Investors need to be willing to accept volatility risk with a portion of their capital they invest to achieve higher returns over longer periods of time. It they are bothered by this fluctuation in portfolio value, there should be a re-assessment of the investment plan and adjustments to the asset allocation to reduce volatility worry about the future.

If you have specific questions or concerns, please connect with your Integra Capital Advisors representative