A Commentary on the Correction

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Global stocks 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 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.  

- 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.

1. MSCI All Country World Price Index

2. Based on S&P 500 Price Index and excludes the most recent decline