New Albany
Investment Management

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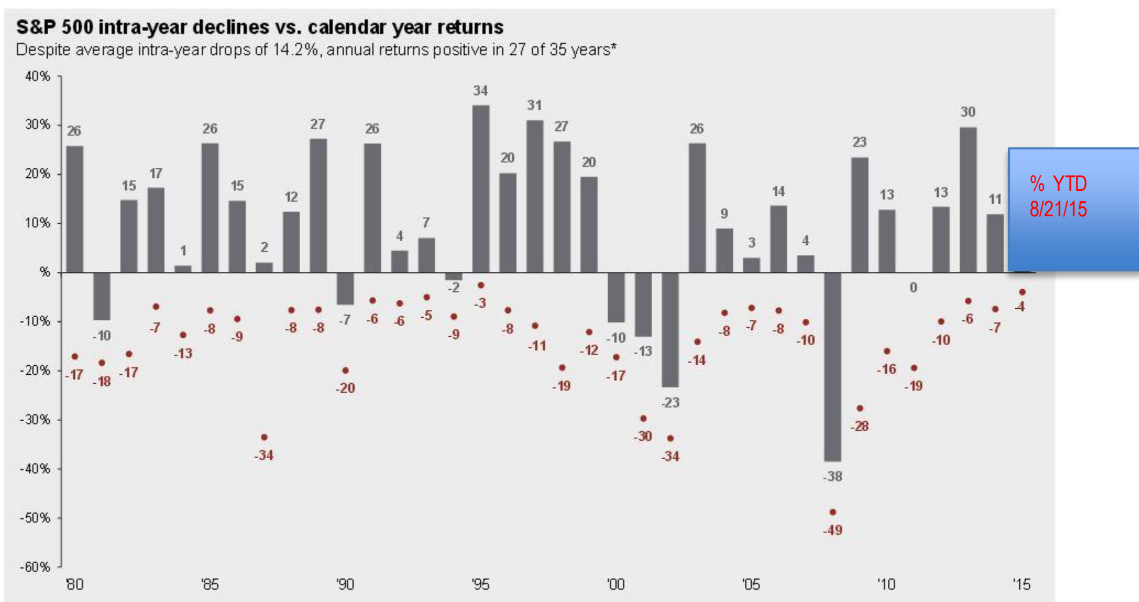
Market Break (Shake) Out

After trading for nearly six months in the narrowest range in over half a century, the markets finally broke out and decidedly down in one of the largest moves not seen since 2011. A combination of fear over the Federal Reserve initiating rate increases, a Chinese currency devaluation, falling oil prices, and traders on vacation have fueled one of the steepest one week declines not seen in over four years. Is this market action warranted given the economic news? What should investors expect for the rest of the year?

Perspective on Market Volatility: The last several years have been relatively calm for the U.S. stock market. Notably, this bull market has gone 1,418 calendar days without a 10% correction – the third longest such streak in the last half-century. Investors have been lulled into a false sense of reality of narrow trading ranges and large positive returns. This 'utopia' investing environment has been fostered by coordinated easy monetary policy by central banks around the globe. But now that the Federal Reserve is breaking step with the rest of the world policies and is seriously contemplating raising rates, the markets are moving back to more 'normal' moves. What is normal?

This past week, the market dropped -5.8% and is down -7.5% from its recent high. Though this decline is large, history shows it is not unusual. **In fact, it's been 20 years since we experienced a year without at least a 5% decline. Even with the rout last week, this year represents one of the least volatile years in recent history.** Below is a chart that shows the annual performance of the S&P (gray bars) and the intra-year decline (red dots). As can be seen, yearly trading ranges of 15-25%, and declines of -5 to -10% are quite 'normal'.



-3 Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

(Note as of 8/21/15, the S&P return for the year is -3.0 %.)

China's Currency Devaluation was the tipping point:
Many factors have converged and are playing into the volatility of the markets, but the tipping point came when China moved to devalue its currency last week. Although the move was small (-2%), it was viewed as a sign that the Chinese economy is slowing even faster than originally expected. This perception fueled fears of a global slowdown, hence investors hit the exits. But the real motivation behind the move is China's desire to have its currency join the 'special drawing rights' (SDR) basket of currency. The SDR has been established by the International Monetary Fund (IMF) and consists of an elite group of currencies including: the US dollar, Euro, Pound, and Yen. To join SDR, each currency must be allowed to float freely, allowing the markets to determine the relative price. Though small, China's move last week shows its desire and willingness to move to a more market-oriented currency.

The chart below shows the huge rise (over 60%) of the Chinese currency verses the Euro over the last seven years and puts into perspective the relatively small downward adjustment initiated last week.

Net, although China's growth is slowing, it is still the fastest growing economy in the world and will continue to be an engine of world growth. It is very much in China's interest to keep their economy growing.

Looking ahead, the markets are likely to remain volatile at least thru mid-September- after the Fed meeting- and perhaps thru the end of the quarter. The markets could fall further and actually experience a "correction" which is officially defined as a 10% decline. This is both healthy and not unusual (but hard to ride through). However, eventually the fundamentals will come back into play. Global growth is slow but it is growing. Every major central bank, except the Fed, is still actively pouring stimulus into their respective economies and global rates and inflation will remain quite low for some time to come. This fundamental backdrop is still supportive of financial assets and should allow the markets to see positive, mid-single digits returns over time. That being said, because global growth is slow, the risk of dropping into negative growth is higher which in turn creates a more uncertain and volatile investment climate.

Portfolio Strategy: The market has not only fallen hard but there has been a rapid rotation of leadership both on the way up and way down. For example, growth sectors had been the shining star all year, but quickly became the worst performing sector last week. On the flip side, corporate bonds turned in their best performance last week after declining all year. Thus trying to concentrate the portfolio in one area or 'time' the market is very dangerous. Instead, the key to riding through volatility is to identify and measure the specific risks and to keep exposure broadly diversified. The investment strategy is working properly as evident of how well the portfolios are holding relative to the broad market.

In times like this, more discussion may be desired. Please contact me with any questions or concerns.

Kind Regards,
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