

October 13, 2014

Correction

As we have previously noted, the September-October timeframe has traditionally been a difficult period for the global stock markets. This year has been no exception to that rule. The “bears” were growling on Wall Street this past week as stock prices retreated across the globe.

I am studying the recent market weakness for opportunities to put capital to work in the global equity markets. There is a grab-bag of problems the world is facing – from economic to political to military to potentially pandemic disease catastrophes. ***Bull markets climb a wall of worry***, and there is plenty to worry over currently. I don't casually dismiss the problems the world is facing – there are very good reasons to recognize all of the issues that surround us. But, there are ***strong historical reasons to consider putting some capital to work in the global financial markets***. Please read on.

Starving for Growth

The world is starving for growth. Here in the U.S., growth (change in GDP) has accelerated, but great swaths of Europe are on the brink of economic recession. The bastion of European economic growth (that phrase is probably an oxymoron), Germany, is stumbling. German industrial production declined 4% in August, the biggest monthly decline since the lows seen during the last recession. Additionally, Germany's real GDP contracted 0.2% in the 2nd quarter of this year. Again, Germany has been the economic powerhouse of Europe for some time – they are now struggling to maintain any growth at all.

The countries showing strong deterioration in PMI Indexes (manufacturing Purchasing Managers Index – which suggests manufacturing health going forward) are: Australia, Austria, Brazil, France, Germany, Greece, Israel, Korea and Poland. Areas where the PMI Index is between 50 and 51 (barely keeping their heads above water) are China, Indonesia, Italy, Russia, Singapore, South Africa, Switzerland and Turkey. The United States, at a PMI level of 56.6, is currently the strongest read in the developed world.

Why are the European economies so weak? There are a number of reasons, which we recently highlighted in our piece from October 6th – *The U.S. is Taking the Growth Gold*. For reference purposes, you can see this piece on www.marinerwealthadvisors.com. Along with the factors outlined in that piece, Europe is struggling economically from the sanctions being imposed on Russia due to Vladimir Putin's expansionist desires in Ukraine.

China's true economic growth rate is a mystery. This past week the World Bank cut their estimate

of China's economic growth rate. The "official" target growth rate, set by the central planners in Beijing is 7.5%. The World Bank is now calling for 7.4% GDP growth from China. I believe that number to be wildly optimistic. China's official economic data has always been suspect of fudging, as the central planners need to put on a good face to the public and outsiders. So, how rapidly is China truly growing? It is guesswork, but the pure data I've seen recently suggests China's growth to be in the 5.5% - 6.5% range, half speed of the growth heydays of earlier years.

The World's Stock Markets Take Notice

Over the last number of weeks, the world's traders and investors have taken notice of these disappointing trends – and driven risk-based asset values lower. Many of the world's leading equity markets are now officially in correction territory – down at least 10% from their recent highs. The glaring exception to this is the S&P 500 index. Even in the U.S., the Russell 2000 Index (small capitalization stocks) has now entered into correction territory. Below are details as to returns from recent highs for many of the world's larger, more developed stock markets.

Index	Recent High	Close – 10/10/14	% Change
S&P 500 Index	2019 (September 19)	1906	-5.6%
Russell 2000 Index	1208 (July 3)	1053	-12.8%
Frankfurt DAX Index	10,033 (June 10)	8788	-12.4%
Paris CAC Index	4598 (June 10)	4073	-11.4%
London FTSE Index	6904 (September 4)	6339	-8.2%
Tokyo Nikkei Index	16,374 (September 25)	15,300	-6.6%

With a lack of growth in many areas of the world, except the U.S., the value of the U.S. dollar has risen significantly in relation to most major currencies. For example, over the last 3 months, the Euro has depreciated by 6.7% to the dollar and the Yen has declined by 6.1% to the greenback. So, if you are a U.S. investor, the returns noted above from the European and Japanese markets need to be adjusted *downward* by between 5% and 6% due to the dollar's exchange rate appreciation.

We have been anticipating a correction in stock prices in the U.S. and overseas. We now have it. A price correction is a price decline of at least 10% from the highs.

We understand why stock prices have been weak – a lack of economic growth coupled with a variety of socio/political dislocations, which have led to higher risks of a wide variety on the investment landscape. The correction is upon us – what should an investor do at this stage? First, consult with your Wealth Advisor. A standard answer to that question isn't appropriate. However, we need to revisit our discipline – our Four Cornerstones approach to equity market analysis prior to making a blanket statement regarding potential action due to the current correction in stock prices.

Four Cornerstones – A Change Has Taken Place

Our regular readers are aware that our Four Cornerstone discipline has led us to the conclusion that a tactical neutral position is warranted. To refresh, our Four Cornerstone analysis views four variables that have historically guided the risk/reward landscape for equity investors. In response to the recent correction, we have altered our interpretation of the Four Cornerstones. Our current read

of our Four Cornerstones is:

1. Valuation. U.S. stocks are richly valued in relation to historical norms. Our study of four valuation variables over two different comparative time horizons suggests U.S. stocks are overvalued by 9%. On the other hand, with the recent correction, foreign developed market stocks are undervalued by 8%. *By our analysis, global equity valuation levels are back in line with longer-term historical norms. While the U.S. market still appears marginally overvalued, from a global perspective, we now count the Valuation Cornerstone as a stock market neutral.*
2. Monetary Policy. We measure the growth rate of M2 (broad money supply) and compare that growth rate to trailing nominal GDP growth. This measure tells us if Federal Reserve monetary policies are accommodative or restrictive. If money growth outstrips the real economy's use for that monetary growth, the excess normally finds its way into the financial markets, bolstering asset values. Over the last 12 months, M2 supply has grown by 6.1%, while nominal GDP has grown by 4.0%. **We count Monetary Policy as a stock market positive.**
3. Projected Earnings Growth. This is perhaps the most powerful of our cornerstones, as our studies show the direction of earnings growth has positively correlated with the direction of stock prices 71% of the time over the long-term. We believe the average company in the S&P 500 Index will show earnings growth of 8% over the next 12 months. **We count Projected Earnings Growth as a stock market positive.**
4. Crowd Sentiment. This is a contrary indicator – when investor sentiment is extremely high, stock prices have tended to struggle over the following 12 months. Historically, when more than 65% of investors are polled as “bullish,” the stock market has generated a mere 2% average return. Investors' attitudes have been very bullish recently, that is until the recent correction. Bullish sentiment has retreated rapidly over the last 4-6 weeks along with stock prices. **We now count Crowd Sentiment as a stock market neutral.**

Our Four Cornerstone analysis had lead us to take a neutral position for the equity markets, in general. The recent change in the Cornerstone analysis leads us to a more positive view towards equity markets, generally. This isn't to say that stock markets don't contain significant shorter-term risks – they very well may. But, weighing all of the evidence leads us to believe that significant risks are starting to be “priced-in” to a number of equity markets – particularly major markets overseas.

Longer-Term View

We believe the U.S. (and probably the rest of the world) is experiencing a new, major *secular bull market*. We believe the bull market started, not in 2009, but by our calculations, in 2012. If we are right, we shouldn't expect stock prices to rise, uninterrupted. What we should expect are stock prices to rise, on balance, over a number of years.

We have numerous technical reasons behind our longer-term thoughts, but remember, historically, ***stock prices have risen 67% of the time. Over the last 100 years, the Dow Jones Industrial Average has risen 67 years and declined 33 years. Also, for true investors, there have only been two 10-year periods in the last 100 years when stock returns have been negative over a 10-year period (late 1930's and the 2008-2009 period). In other words, over the last 100 years there have been 4 years when 10-year rolling returns have been negative for stock investors.***

Historically, stock market returns have been very lumpy, in nature. For example, if an investor had simply invested \$100,000 in the S&P 500 index on 12/31/79 (which is impossible because you cannot invest directly in an index, but bear with me for the example's sake) and held that investment through 10/10/2014, the investment would have grown to \$1,765,592. ***If the same investor had been hapless enough to have eliminated their investment during the 30 best days of returns during that 34 year period, that \$10,000 investment would only be worth \$337,910 today.***

On the other hand, if the investor had been astute enough to avoid the 30 worst days of market activity during the period of 12/31/79 to 10/10/2014, the initial \$100,000 investment would be worth \$13,515,890, picking up an additional \$11.8 million, as compared to the “buy and hold” investor.

The point we are attempting to make is, historically, it has paid for investors to avoid the periods of highest market risk. That is the core reason we offer our Four Cornerstones analysis technique, in an attempt to identify those periods of maximum market risk.

Our theory is that the risks appear manageable. Investors should feel more comfortable, given the current correction in stock prices to deploy more capital into the global equity markets.

Closing Words

As the title of our piece states, the world's equity markets have been experiencing a correction in pricing. Ron Chernow, the famous American writer, journalist and historian, once said when asked about stock market corrections:

Stock market corrections, although painful at the time, are actually a very healthy part of the whole mechanism, because there are always speculative excesses that develop, particularly during the long bull market.

In other words, corrections, while painful when they are occurring, are a useful part of the investment process...a process true investors embrace.

We will be back next week.



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