

June 29, 2011

Mid-Correction: Different year similar story

After experiencing several positive quarters in a row, this quarter is looking more likely to be a negative one for stock markets.

Corrections are a natural part of market cycles. According to market watchers, Bespoke Financial, since 1928 the S&P 500 index has had 6 negative weeks in a row 17 times. We barely avoided our 7th last week which is much more rare. After moving upward for a period of time, the market always finds reasons to pull-back, pause and in some cases, re-charge for another move forward. Business cycles are full of cautionary moments and worries always emerge that provide the reason for the pullback. However pullbacks create the foundation of the next leg during a recovery. This seems to be one of them.

Déjà vu?

In some ways this feels like this time last year. If you recall, in 2010 the market hit highs mid- April before beginning a slide that lasted through June. Economic growth had slowed and late spring/early summer was dominated by discussion over whether we would double-dip back into recession. Concerns about budget issues in Europe; Greece, Portugal and Spain in particular also dominated the news. The double-dip fears were not realized and the European concerns were calmed, temporarily at least.

Between July and the end of August the market drifted higher. Early September the next move forward really took hold and continued through the end of April, 2011.

Chief Equity Strategist at Raymond James, Jeff Saut, noted that in his 50 years of recording market action, this 194 day buying-stampede cycle in the market, occurring without more than a 3-day pullback, made this the longest buying-stampede he has ever recorded. Therefore, it is natural that a pullback and possibly a negative quarter were in the cards.

Reasons for this correction

The energy for this correction began to materialize March 10th with the Japanese earthquake and tsunami. Business was disrupted in Japan for a time, especially in manufacturing. This trickled down to businesses relying on parts made in Japan, such as automotive and technology. This is expected to be temporary, but has impacted stock prices.

Investors also appear to be struggling to reconcile the micro outlook – U.S. corporate profit margins are at impressive levels and earnings are robust – with anxieties about the macro picture, which is dominated by fears of an economic slowdown in Asia, squabbling in the euro zone over bailing out Greece, and the current impasse in Washington over how to cut the federal deficit and whether to raise the nation's debt ceiling. In addition, recent U.S. economic news has not been encouraging, with unemployment remaining high and the continued slide in housing prices.

June 30th marks the end of the Federal Reserve's debt repurchasing program, "Quantitative Easing 2" or "QE2". This will have significant effect in the markets with the removal of a major buyer of U.S. debt, and in recent weeks the markets been adjusting to the removal of this extra support. At this point, the

Fed does not plan on continuing the program, believing that at some point this recovery has to stand on its own. Fears of a worst-case scenario impact to markets as a result of QE2 ending are overblown though. The Fed's intention is to maintain ownership of the amount of U.S. debt it currently owns. It does not plan to flood the market by immediately selling the U.S. debt it currently holds, which would have a negative impact.

QE 3?

Is the recent release of oil reserves by Washington just another version of QE3? Rising oil prices due mostly to disruptions in Libya and a weaker dollar, also added to negativity as consumer worried about how high prices would rise. The June 23rd surprise release of 60 million barrels of oil by the U.S, and other European members of the International Energy Agency (an alternative organization to OPEC founded out of the 1974 oil crisis) is a game changer. This policy shift by Washington will reduce price spikes and drive speculators from the market and is a clear signal to OPEC that it will not tolerate any attempt to restrict the supply of oil by its members.

There is no question this was a political move that will be controversial. Even though the release of 60 billion barrels represents only about 3 days worth of U.S. consumption, the short term consequence of this historic move is that gas prices, (that were already declining due to the aforementioned weaker economic data when the action was taken) should drop. However this effect may be short lived since many states in the U.S. are slated for tax increases on gasoline in the coming weeks. Thus this may not have the direct financial stimulus the government desires as a byproduct of their action. In any event, Washington has sent a message to oil producers and market speculators that oil prices will not be spiking in the near term. Be certain though that once the world economy starts to accelerate, oil prices will rise. We will be closely watching as it relates to the recovery.

What next?

Bulls and bears constantly contend for control of the market, with each side prevailing for varying periods of time before giving way to the other. And while short-term fluctuations provide interesting statistics – for example, the Dow's six-week slide was its longest since 2002 – what ultimately matters is the long-term trend and, of course, the returns in your individual portfolio.

Currently, the longer-term upward trend for the market has not been broken. This is a time to be cautious, but not to become too bearish. Bank lending, corporate profits and personal savings rates have all been on the rise. Housing and unemployment will continue to weigh on the U.S economy for a longer period of time but will not drag us back into a recession. After a temporary slower period of economic growth, multiple economist and market strategists we follow regularly indicate an expectation that growth should reaccelerate as we move through the year.

What are we doing?

We are closely monitoring several economic indicators for signs of the end of this soft patch. Our contention is that at this point downside risks are still manageable with a slow growth global outlook, and dividend paying investments with a high quality bias.

A long period of seemingly bad news can be unsettling and lead to doubts over whether your portfolio is positioned correctly. However, significant changes in your financial plan should only be made after careful consideration of your overall situation, not in response to market fluctuations. If you'd like to

discuss your investment portfolio, feel that your risk tolerance has changed – or if you have any other questions or concerns about your overall financial plan – please give us a call.

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