Economic and Market Insights

August 25, 2015

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After the Big Drop, What's Next for the Market?

Commerce Trust Chief Economist and Director of Fixed Income Scott Colbert, CFA, discusses the causes of recent market activity and what might be on the horizon

Q. The US and Global stock markets are now formally in a correction phase (defined as at least a 10% decline). Can you provide an overview of what is going on?

A. Thursday through Monday's domestic stock market sell-off was serious – a 1,477 point plunge in the Dow Jones Industrial Average, representing an 8.5% loss for the three day period and 13.4% off Dow Jones market high in May. Global stock markets saw similar downward price pressure led by yesterday's 9% decline in the local Chinese stock market. To put this into a world-wide perspective, stocks account for about one-fourth of global wealth (about $70 trillion dollars). So these past three market days have erased approximately $6 to $7 trillion of global equity wealth.

The US stock market correction has been driven by five primary factors:

1) Weak Global Growth: The slowdown in China is rapidly turning into a hard landing with potential contagion-like "knock on" effects.
2) High Valuations: U.S. stock prices were above average by almost any measure.
3) Time and Our Extended Bull Market: It's been about two and a half years since we've had a 10% correction, in spite of the fact these typically occur on average twice a year.
4) No Earnings Momentum: The rising dollar had sapped year-over-year earnings growth from our larger companies as their overseas earnings translate into fewer dollars.
5) Potential Interest Rate Hike: Market expectations had been that the Federal Reserve would begin to raise short-term interest rates in September.

Q. Everyone is focused on China. How big a factor is China?

A. Clearly, China was the catalyst that sparked this market sell-off. China is the world's second largest economy representing about 13% of global GDP. And there is no doubt their growth has been rapidly fading as evidenced by falling home prices, rising debt levels, higher delinquency rates, and marginal growth in car sales. Despite this cooling off, China's Shanghai Composite Index still rose by 150%. But recently, Chinese stocks have been in a free fall, giving back all of this year's gains in the past few months.

A big reason for their stock market rally was that a lot of ordinary Chinese people began investing (gambling?) in the stock market for the first time. More than **40 million new stock accounts** were opened between June 2014 and May 2015. And many have been buying stocks with borrowed money with margin debt nearly twice that found in the U.S. markets. Unfortunately, despite Chinese government intervention, their stock market has yet to find a bottom. And valuation remains poor with the overall P/E ratio nearly 30 and a median P/E of 60. With valuations still stretched in China, we expect more downward pressure.

Q. Is it more than just China?

A. It's much more than just China. Clear evidence of weak overall emerging market growth (39% of global GDP), along with a persistently sluggish Europe and Japan, made it harder for the markets to ignore the likely impact to top line sales and earnings prospects. All of this has largely manifested itself in the "commodity" space as most raw material prices have been falling since 2011-2012 while oil prices have fallen to their February 2009 recession lows.

Q. Is there more to come? What are the expectations for the coming weeks?

A. Nobody knows for sure, but we believe we are still in a longer-term secular bull market and doubt we are about to tip into bear market territory as defined by a 30% decline in stock prices. On average, while we are in a bull market, since 1900, there have been 20 corrections of more than 10% with an average decline of 13% over 70 calendar days. The S&P 500 peaked on May 21 and has fallen 11.2% over the past 94 days. So far, despite the recent turmoil, this has been a pretty average correction. But this provides only modest comfort when viewed in a historical context since we have seen declines up to 23% in prior corrections and corrections that have lasted up to 234 days. We would be hard pressed to suggest at this time that this correction has run its course. Still, with a 10% correction long overdue, we would note that **corrections in equity markets are normal and healthy and should be expected from time to time**. As they are impossible to time, this volatility is the "cost" of achieving equity-like returns over time.

Q. Does this mean I should change my strategy, and if so, what is Commerce Trust recommending?

A. As those who follow our recommendations closely know, we have been recommending a tactical overweight to our clients' stock allocation until we reduced our allocation back to neutral in June, suggesting clients put those monies into bonds. Secondly, we have suggested to clients that they avoid, as best they can, the "commodity" market in general and, as a result, we have a 0% recommendation to commodities and precious metals. Finally, we have suggested that clients remain relatively U.S.-centric and underweight their longer-term allocation to international and emerging market securities as we expect the dollar to continue to strengthen.

But those are modest “tweaks” to our client’s long-term strategic asset allocations, and we rarely recommend large swings one way or the other away from those longer-term allocations since it is very difficult to time shorter-term swings in relative asset class valuations. As such, we certainly don’t recommend investors panic into this sell-off and attempt to time the correction by going to cash. Rather, we simply suggest investors stick to their long-term strategic mix of stocks, bonds, and alternatives. And with stock prices falling, we will likely suggest that investors rebalance in the near future, selling down some of their bond “winners” to reallocate back into a less expensive stock market.

Q. Does this mean I should change my strategy?

A. No. We believe in our strategy of broad global diversification, that the portfolios we have helped build are appropriate to client’s individual financial plans, and that, while big market drops are worrisome, it is just noise in the long-term and should have no major impact on their life plans.

If you have any questions about your portfolio or your financial plan, please call your Commerce Trust advisor. We are available any time to answer your questions and to ensure you are on track to meet your goals.