Economic and Market Insights
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Is this a bear market or a market correction?

The "bear" word is back in the investment lexicon as economists debate whether recent market turbulence is a normal cyclical disturbance or a bear market possibly leading to recession. With investors anxious to regain a solid floor underneath their portfolios, we thought it was a good moment to talk with Commerce Trust Chief Economist Scott Colbert about what to look for next.

Q. What do you tell your investors when the markets are as volatile as they have been?

A. It is natural to feel concern and easy to forget about the longer-term investment picture during large market fluctuations. And having become used to below-average volatility in the equity markets for the past six years, any increase in downward price movement has an exaggerated negative impact on investor psychology. These market cycles have occurred with regularity in the past and will continue in the future. We reach out to our clients and encourage them to call us if they are feeling any anxiety whatsoever. One of the advantages of an advisor is that he or she can help clients see the larger perspective.

Q. Are we in a temporary correction or something more ominous like a bear market or recession?

A. I'd certainly call it a major disruption and a deep correction, but the fundamental U.S. economy is still well supported by job growth and low inflation. We do not think this market turbulence will necessarily lead into a bear market or recession, although it is a warning sign.

Q. What is the difference between a correction and a bear market?

A. A correction is generally considered to represent a downdraft of 10% or more and a bear market is much worse – defined by a 20% or more steep decline. Since the early 1920s, bear markets have only occurred 10 times and the key driver in eight of those 10 bear markets was a recession. The average drop of those 10 bear markets was around 45%. However, for our situation now, we do not believe the oil price collapse, the stronger dollar and China's "contagion" are likely to impact our economy directly enough to pull us into a recession. Our leading indicators are still rising, although there is no doubt our economy is cooling.

Q. What should investors do now that this market turbulence has occurred?

A. Talk to their respective advisors and discuss their particular situation. Some investors may want to hit the panic button and sell out of fear, which is unlikely to be in their best interest. It's times like these that a trusted financial advisor can take the emotion out of investment decisions and help keep the focus on the long term.

Q. How often can we expect corrections then?

A. With stocks relatively expensive, a 10%-plus but less than 20%-plus correction occurs about once per year. Since 2009, we have only had three 10%-plus corrections, about half as many as normal.

Q. Are there any other factors to support the idea we are not falling into a recession?

A. In general, recessions are foreshadowed by several months of declining leading economic indicators and often sparked by a rapid rise in commodity prices. We certainly don't have that now. In aggregate, with about a 12- to 18-month lag, lower energy prices are a net positive for the U.S. economy. So at this point, our read is this is not an economic recession, but simply an earnings recession, sparked by falling commodity prices and a stronger U.S. dollar that will lead to a deeper than average 14%-plus correction, which will open up some much needed equity valuation. A market bottom will occur when base energy prices stabilize (soon), when the Federal Reserve hints that it is likely to be more gradual than its original rate-hiking strategy, and when the Chinese yuan devaluation runs its course. This will take some time.

Q. Is there a danger of herd mentality here?

A. Yes, and that's why we believe investors should check in with their advisors. Investors often overreact and base their opinions on new information, either for individual stocks or the market in general. They can quickly look to sell – the "sky is falling" – at the first hint of bad news, when in reality nothing long term has changed. Studies have shown that the overreaction is often greater than the actual impact of the news.

Perhaps the most important lesson to be learned here is to retain perspective. Investment professionals can help you revisit your long-term goals, measure how you are tracking against your original asset allocation and risk tolerances, and keep a cool head.

<u>Summary:</u>

- Fundamentally, the U.S. economy is still expanding.
- While uncomfortable for investors, the domestic market downturn is not likely to evolve into a bear market or signal an imminent recession.
- Investors often overreact in situations like this, so talking with your advisor is a good idea before taking any action