Investment Update

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WEALTH MANAGEMENT

September 2014

The Market's Burning Question

When will the Fed start raising interest rates? Will Europe go back into recession? What's happening with gold? Questions about the markets and the economy are never in short supply when we meet with investors.

Lately, another question has seized the investor psyche: The timing—and depth—of the next market correction. As we head into the last quarter of 2014, three years after the market's last correction, this question has been asked more frequently and with more urgency.

Corrections can be a natural and healthy part of an economic cycle, paving the way for the market to continue moving higher. Typically, a correction that is not caused by an economic downturn will occur every two and a half years or so. While this may sound worrisome, investors should keep in mind that a correction doesn't necessarily lead to a recession. We don't see a recession coming any time soon, as much as we could be overdue for a correction.

Investors are smart to ask "when, and how deep." If they understand the potential risks of a correction, and they have a corresponding action plan for when it hits, they can hopefully identify potential opportunities.

Anatomy of a Correction

A correction is defined as a loss of 10% or more. To answer the "when, and how deep" question, consider Exhibit 1, which looks at all corrections not associated with economic recessions since 1971. The exhibit shows that during 13 of the 18 corrections, the market was actually up a year later, even when measured from the start of the downturn. It also shows the market gains an average of 5% a year later (with a median return of 8% in the same time period).

Why do corrections happen? The reasons have ranged from the setting of wage and price controls in the early 1970s, to the toppling of hedge fund giant Long-Term Capital Management in 1997-1998, to fears of a Eurozone breakup in 2011.

Exhibit 1—A Closer Look at Market Corrections since 1971

Global Equities*				
Peak Date	Trough Date	Peak-to-Trough Decline	1 Year Return After Start of Decline	Calendar Days to New Peak**
30-Apr-71	19-Nov-71	(10%)	9%	249
15-Jul-75	1-Oct-75	(11%)	8%	174
31-Dec-76	6-May-78	(12%)	(7%)	576
12-Sep-78	15-Nov-78	(9%)	3%	224
5-Oct-79	7-Nov-79	(8%)	13%	107
2-May-84	24-Jul-84	(11%)	12%	135
25-Aug-87	4-Dec-87	(27%)	(14%)	601
17-Apr-91	12-Aug-92	(11%)	(5%)	689
2-Feb-94	9-Mar-95	(11%)	(8%)	529
11-Mar-97	14-Apr-97	(6%)	23%	50
31-Jul-97	12-Nov-97	(11%)	11%	187
20-Jul-98	8-Oct-98	(24%)	11%	170
16-Jul-99	18-Oct-99	(10%)	11%	121
5-Mar-04	13-Aug-04	(8%)	8%	244
9-May-06	13-Jun-06	(11%)	13%	156
15-Apr-10	5-Jul-10	(15%)	4%	238
18-Feb-11	4-Oct-11	(21%)	(5%)	684
19-Mar-12	4-Jun-12	(12%)	9%	179
	Mean	(13%)	5%	295
	Median	(11%)	8%	206

Source: MRB Partners Inc. © 8/2014 and MSCI.
*Local currency.
**Number of days (including non-trading days) before the decline is completely erased.
Note: Includes periods where global or U.S. equities fell by 10% of more, or declines associated with rising or imminently rising interest rates; excludes recession declines.

However, the root causes of corrections usually fall into three categories: Growth scares, oil price spikes and monetary policy. Let's look at each of these reasons and what actions we would recommend for investors.

A Growth Scare—When the Market Fears a Slowdown

Growth scares happen when markets reset their growth expectation downward. When an economy is expected to grow at 3%, and switches gears to a slower 2% growth rate, for example, the stock market moves lower to reflect this reduced outlook. The market can also have a growth scare due to a geopolitical event or out of fear of a financial crisis (again, think Long-Term Capital).

While fear of another hedge fund doing poorly does exist, the main growth fears in today's market have clearly come from geopolitical concerns. The Ukraine crisis, as well as conflict in Iraq and Syria, remain in the market's crosshairs for good reason. Geopolitical uncertainty has a strong history of disrupting markets, and the current situation is no exception.

Action Plan: A geopolitical event can cause a short-term market reaction or lead to a more long-lasting slowdown, depending on its severity and reach. When the economic backdrop is healthy and growing, a short-term pullback can provide investors a "buy the dip" opportunity. The market thus far has been able to shake off ongoing conflicts, and, with current conditions, we expect its resilience to continue.

An Oil Price Shock—The Power of One Commodity to Move the Market

Oil price shocks have a long history of causing markets angst. Oil is an input into so many products, and also has the direct economic impact of causing higher gas prices. These rising prices inhibit consumers' ability to buy products, acting almost like a tax on disposable income that can put the brakes on economic growth. If this brake is applied aggressively, it can cause a recession, as was the case in 1973-1974.

Action Plan: We continue to watch the price of oil very closely. So far, prices have remained stable, and have even declined in the face of rising tensions in the Middle East and Ukraine. Perhaps the rapidly rising production of oil in the U.S. has had some influence on this recent price stability. That said, we recommend investors be ready to take steps to make portfolios more conservative should the price of oil rise dramatically.

Monetary Tightening—When the Fed Rocks the Boat

Monetary tightening has often resulted in corrections in the equity markets, most recently in 1994 and 2004. The uncertainty that rising rates have on the overall economy most directly influences the bond market, but soon ripples into other asset classes as well.

Action Plan: We are closely watching the Fed to gauge when it will begin tightening. If the Fed raises rates because real rates (nominal rate minus inflation) are rising due to a strong economy, the market tends to take these rising rates more in stride. If the Fed takes action because of rising inflation, the correction could be more severe. If we see signs of rising inflation we would recommend more conservative positioning in portfolios.

Conclusion

So what type of correction is most likely? Corrections are difficult to predict, and happen for many reasons. The situations in the Middle East and Ukraine are uncertain, and an oil scare is always a possibility for this volatile commodity. However, we think the Fed could be the catalyst for a potential correction this time. Investors should always have an action plan for these potential outcomes, because in the end, sound planning is the best answer of all.

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