August, 2011

Reversals: corrections and bears

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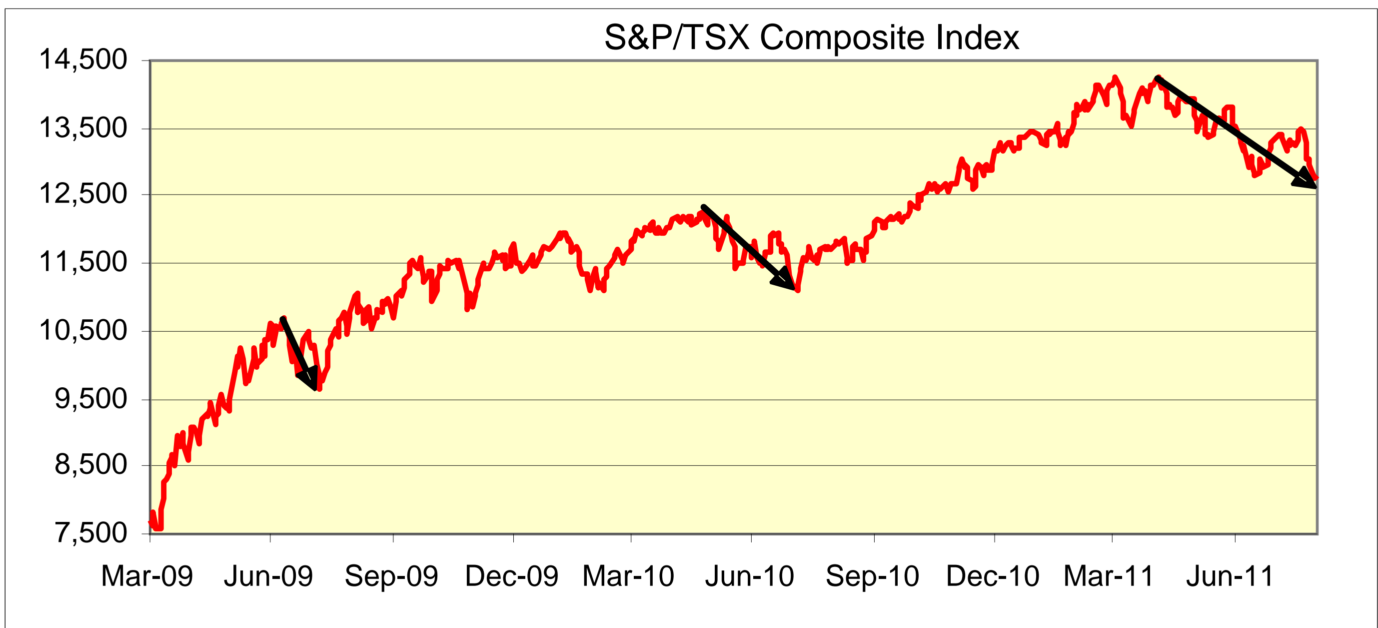
After the market meltdown of 2008-2009, investors can be forgiven for finding the current market environment disconcerting. The "Great Recession" has left an indelible impression on even the most casual market observer. Even though the world's major indexes have gained substantially since their mid-crisis lows, worries over the sustainability of the current recovery persist. And this was only heightened in the second week of August when markets plunged and had a bounce-back. On August 2, 2011, the Dow Jones Industrial Average recorded an eighth consecutive losing session. Had it declined again the next day (on August 3 it rose 30 points or 0.25%), it would have been the first nine-session losing streak in 33 years. Ironically, on August 4, it plummeted 513 points or 4.3%. Inevitably, these kinds of reversals stir emotions and heighten concerns about the possible re-emergence of an outright bear market. It is, however, important to put these kinds of softening periods into context. Periodic weakening and outright corrections are part of the normal movements of the market.

Domestic market

While there are no set rules, a 10% decline in a market index is widely considered to be a "correction." Conversely, an outright bear market is generally declared once a 20% drop has been recorded. Not surprisingly, the broader Canadian equity market, as represented by the S&P/TSX Composite Index (TSX), has never moved in a straight line and corrections have been the norm for bull markets in the past. In fact, the current correction is not the first material decline to affect the market rally that began in March 3, 2009. As the chart below shows, there have been two other significant retrenchments along the way.

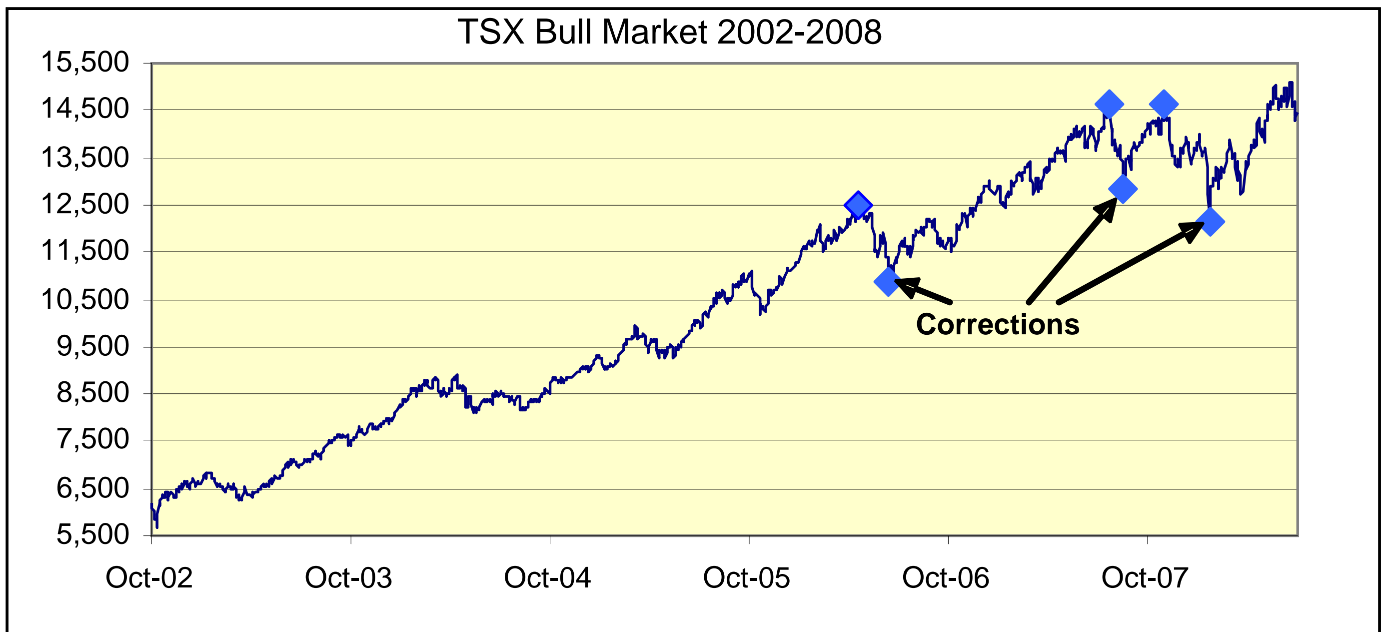


Source: Bloomberg

Between June 11 and July 8, 2009, the index fell by 9.9%, narrowly missing the technical “correction point.” Then again, between April 26 and July 5, 2010 the market recorded a 9.7% drop. As of August 4, 2011 the main index had posted a 13.2% fall from the April 5 close of 14,270.

Previous markets

As can be seen in the graph below, the previous TSX bull market had three corrections. The first stretched from April 19 until June 13, 2006 and carved 12.7% from the index. The subsequent episodes occurred between July 19 and August 16, 2007 and October 31, 2007 and January 21, 2008. These reversals produced index losses of 12.2% and 17.0%, respectively.



Source: Bloomberg

Unfortunately, as the markets in general are not predictable, neither are the corrections that emerge within them. Over the past 60 years, the Canadian stock market has seen seven bull markets and each has seen varying influences from their respective corrections (see Appendix 1). On average, corrections in Canadian markets have occurred just less than three times during each run up and have lasted about five months each time. These historic corrections have also pared the market back by 14.4% on average. However, the averages mask the unique length and depth of each. As a result, the past timing, length and depth of these episodes provides little predictive power. Investors who attempt to time the market and sell out with a plan to buy back in at better levels run a significant risk of either liquidating at low levels or missing the eventual move back to higher levels, or both. Typically, market timers end up selling low and buying high.

U.S. markets

Since the recession ended, the U.S. economy has been slower to improve. In addition, worries over the debt and deficit situations faced by the country have added to equity market concerns. The broader U.S. market entered a

technical correction on August 4, 2011. As can be seen in the graph below, this is now the second correction of the current bull market.

Source: Bloomberg

From April 23 to July 2, 2010, the index fell by 16.0%, helped along the way by the "Flash Crash" of May 6, 2010. As of August 4, 2011 the S&P 500 Index recorded a 12.0% fall from the April 29 close of 1,363.

Elsewhere

Looking elsewhere, a different set of market performance pictures emerge. As can be seen in the table below, the most recent market peaks in Brazil and China occurred well ahead of those within the major industrialized nations. As well, their respective corrections have actually turned into technical bear markets as accumulated declines of 27.7% and 22.7% have appeared. In the world's other major regions, the setback has not been quite as dramatic, in part due to the fact that these indexes had recorded less robust gains once the global market recovery began. In Europe, France stands as the exception as it too has broached the technical level of a 20% bear market decline. Results in Germany and the United Kingdom are more in line with Canada and the United States. In Asia, both Japan's Nikkei 225 and Hong Kong's Hang Seng indexes also reflect a material correction but not a bear market.

Foreign markets – recent peaks and corrections

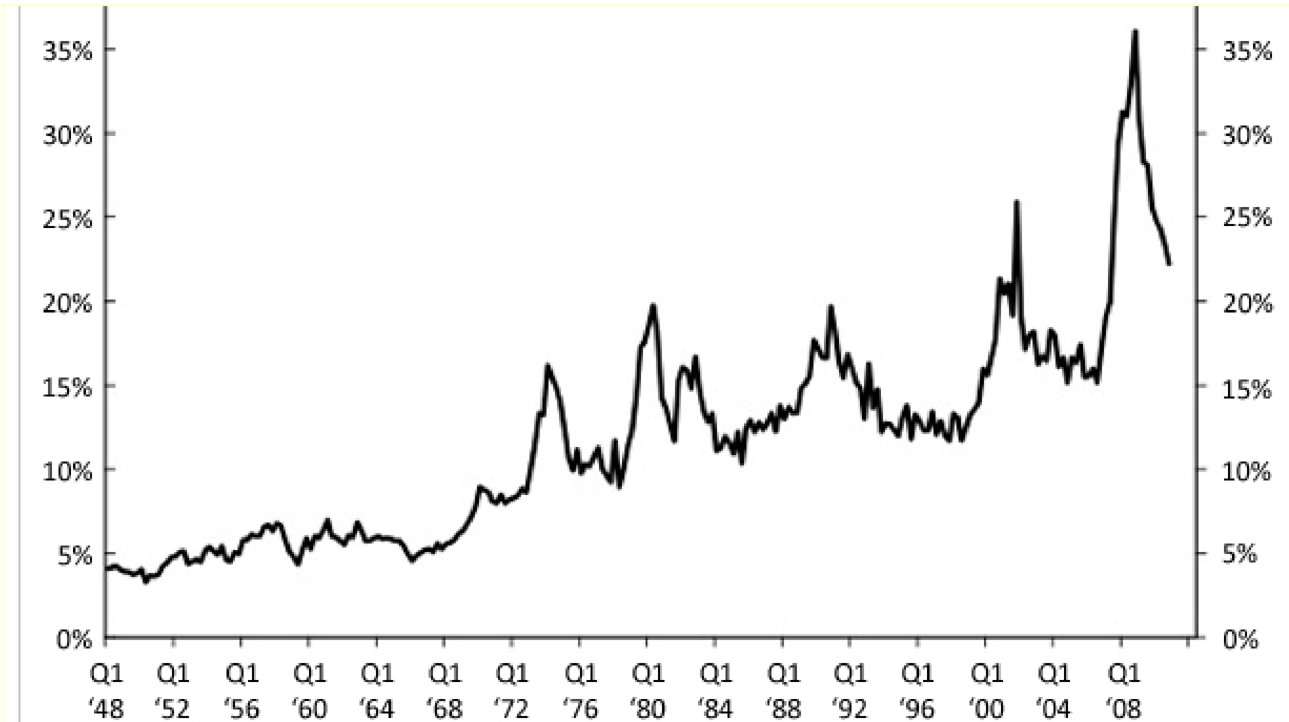
Market	High	Date	4-Aug-11 Level	Decline from high
Mexico - IPC	38,696.24	5-Jan-11	33,322.63	-13.9%
Brazil - Bovespa	72,996.00	4-Nov-10	52,811.00	-27.7%
Germany - DAX	7,527.64	2-May-11	6,414.76	-14.8%
France - CAC	4,157.14	18-Feb-11	3,320.35	-20.1%
U.K. FTSE	6,091.30	8-Feb-11	5,393.10	-11.5%
Japan - Nikkei	11,339.30	5-Apr-10	9,659.18	-14.8%
Hong Kong - Hang Seng	24,964.37	8-Nov-10	21,884.74	-12.3%
China Shanghai	3,471.44	4-Aug-09	2,684.04	-22.7%
Australia - All Ordinaries	5,064.90	11-Apr-11	4,352.90	-14.1%
India - BSE	21,004.96	5-Nov-10	17,693.18	-15.8%

Source: Bloomberg

Valuations

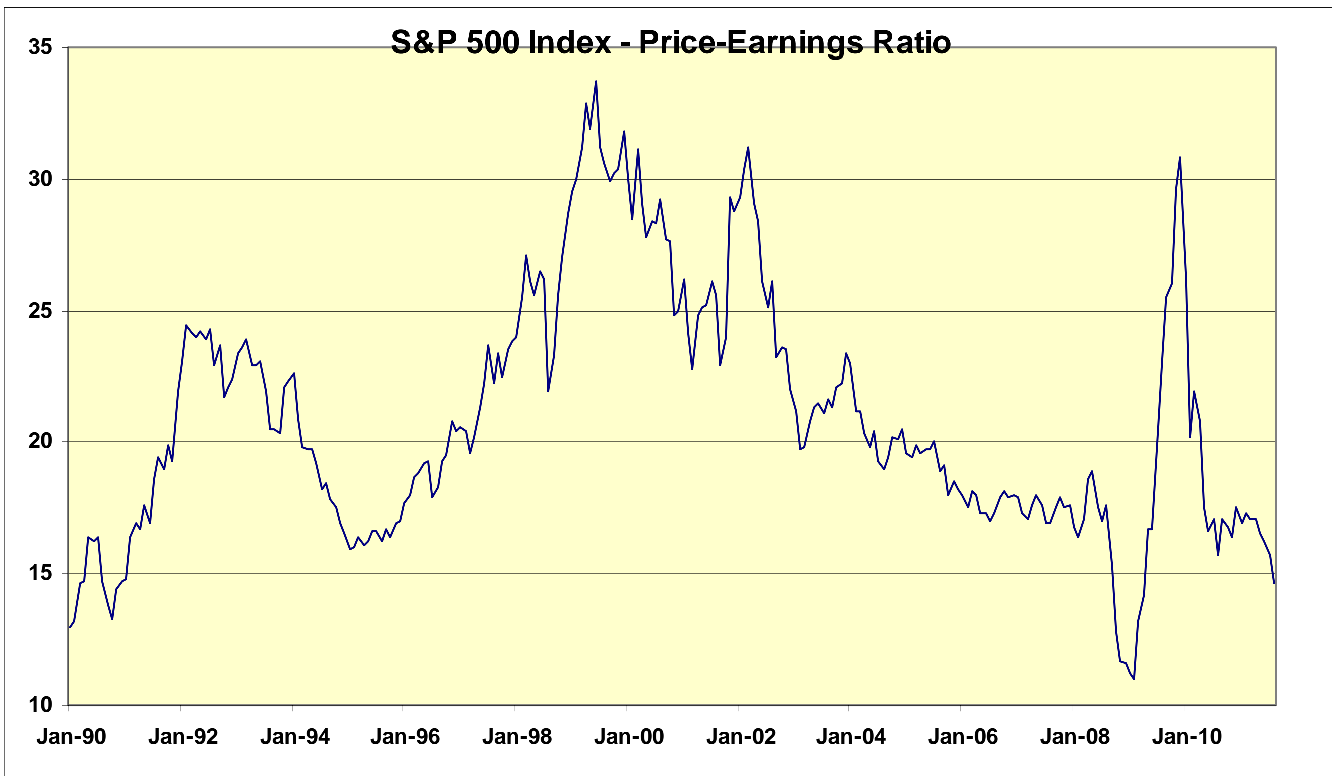
Despite the negativity in the market, some positive elements have emerged. Even though many U.S.-based companies continue to rely heavily on their domestic economy, a trend to greater integration with other regions has become deeply entrenched. Corporate profits, one of the few signs of strength in the relatively weak U.S. recovery, appear to be continuing to weather the storm. In many cases, earnings have come from international operations, particularly in emerging markets that do not have debt problems and other uncertainties which have plagued the U.S. economy and Europe. In fact, Standard & Poor’s recently reported that in 2010, 46.3% of all S&P 500 company sales originated outside of the U.S. This was actually down marginally from the 46.6% recorded for 2009 and was also lower than the 47.9% figure posted for 2008. Another related measure of the diversification of S&P 500 companies into foreign markets is seen in the graph below – which shows the percentage of their profits that come from outside the U.S. This trend is one that has been developing for several decades.

Foreign profits as % of total profits for S&P 500 companies



Source: Citi

Interestingly, the market has been less eager to price these companies to reflect the endurance of U.S. corporate profitability. As can be seen in the graph below, the overall S&P 500's price to earnings ratio remains at a subdued level. Many reasons are held out as justification for the historically cautious pricing by the market. Primary among them is that market participants appear less willing than they historically have to pay for future earnings growth amid the laundry list of uncertainties. Uncertain economic growth in the U.S., American debt and deficit issues, European debt and currency problems and the potential for slower economic growth in countries such as Brazil, Russia India and China top the list. In any event, by traditional measures, these profitable, dividend-paying companies are inexpensive at this juncture.



Source: Standard & Poor's

Conclusions

- Recent market gyrations are unsettling, particularly given the fresh memories of 2008-2009. It is worth remembering that periods of uncertainty, as unwelcome as they may be, are a feature of markets from time to time.
- Attempting to time the market is a risky proposition. It often leads to buying high and selling low.
- Corrections in the equity markets can provide the opportunity to add new positions or rebalance existing ones, when prices are low and market sentiment is weak.
- Taking advantage of professional advice and sticking to a well-defined strategy is particularly important in a challenging market environment.
- Diversification is crucial to capturing the best returns from all regions and having professional advice is key to being able to capitalize on these opportunities.

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Appendix 1

S&P/TSX Previous Corrections			
Bull Run	**Correction Period**	**Duration (months)**	**Market Decline**
December 1957 - May 1969			
	Jul 59 - Jul 60	12	17.2%
	Dec 61 - Sep 62	9	18.4%
	Jan 66 - Sep 66	8	17.1%
	Sep 67 - Mar 68	6	11.7%
	Number of corrections	**Average**	**Average**
	4	8.8	16.1%
June 1970 - October 1973			
	Apr 71 - Oct 71	6	13.3%
	Number of corrections	**Average**	**Average**
	1	6.0	13.3%
December 1974 - November 1980			
	Jun 75 - Oct 75	4	11.8%
	May 76 - Nov 76	6	14.5%
	Feb 80 - Mar 80	1	18.0%
	Number of corrections	**Average**	**Average**
	3	3.7	14.8%
June 1982 - August 1987			
	Dec 83 - Jul 84	7	16.6%
	Number of corrections	**Average**	**Average**
	1	7.0	16.6%
October 1990 - April 1998			
	Jan 16/92 - Oct 14/92	9	12.8%
	Mar 23/94 - Jun 24/94	3	14.1%
	Sep 19/94 - Jan 30/95	4	17.1%
	Mar 10/97 - Apr 14/97	1	10.3%
	Oct 7/97 - Jan 12/98	3	13.5%
	Number of corrections	**Average**	**Average**
	5	4.0	13.6%
October 1998 - September 2000			
	Jan 8/99 - Mar 3/99	2	10.0%
	Mar 24/00 - Apr 14/00	1	15.7%
	Number of corrections	**Average**	**Average**
	2	1.5	12.9%
October 2002 - June 2008			
	Apr 19/06 - Jun 13/06	2	12.7%
	Jul 19/07 - Aug 16/07	1	12.2%
	Oct 31/07 - Jan 21/08	3	17.1%
	Number of corrections	**Average**	**Average**
	3	2.0	14.0%
Averages - All Periods	**Number of corrections**	**Average**	**Average**
	19	**4.6**	**14.4%**
Oct 2002 - Present			
	Apr 5/11 - Present	4	12.8%