

THE MASTERS

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A MID-YEAR CORRECTION

Even some market bulls had been expecting it - and here it is.

Presented by Gary Mastrodonato, CEA

August 4: the Dow's toughest day since December 2008. On his 50th birthday, President Obama watched Wall Street cast a no-confidence vote in the economy he had been assigned to turn around. The Dow Jones Industrial Average sank 512.76 and experienced a correction Thursday, with the S&P 500 (-60.27) and NASDAQ (-136.68) also down more than 10% from spring peaks.¹

Developments overseas generated anxiety on Wall Street. Citing “renewed tensions in some financial markets in the euro area”, the European Central Bank abruptly announced a bond-buying program Thursday, a distinct reaction to fears that Italy or Spain might need a bailout from the European Union. ECB president Jean-Claude Trichet stated that “downside risks may have intensified.” The ECB didn't detail what debt securities it would buy or the amount of the purchases. Early indications hinted that the campaign would be modest. The ECB broadened the scope of its lending to Eurozone institutions at its benchmark interest rate this week in a move to aid feeble banks; the Bank of England kept its key interest rate at 1.5% and the ECB held its key rate at 0.5%. These firefighting moves did little: the FTSE 100, CAC 40 and DAX all dropped between 3.4%-3.9% on the day.^{2,3}

Japan's central bank sold 1 trillion yen Thursday in an effort to weaken the currency while also announcing an increase in asset purchases. This move followed the Swiss National Bank's Wednesday decision to reduce interest rates to near zero to try and weaken the Swiss franc, which had climbed 10% versus the euro in July. The dollar went 2.3% higher against the yen on the day.^{4,5,6}

Gold & oil posted losses on the firmer dollar. Gold futures slipped 0.43% Thursday to \$1,656.20 per ounce; oil pulled back 5.77% to fall to \$86.63 a barrel.⁷

Treasury prices rallied. The yield of the 10-year note went down 15 basis points to 2.48%, the biggest descent since June 2010; 2-year note yields fell to a new low of 0.26% on Thursday.⁸

Stateside headlines aided the market descent. JPMorgan scaled back its Q3 2011 U.S. growth forecast by 1% Thursday, and Bank of NY Mellon said it would begin to collect fees from “large depositors” which had affected its capital ratio. The Labor Department announced weekly jobless claims had slightly decreased to a seasonally adjusted 400,000, basically unchanged from last week; Wall Street also had Friday's

unemployment report on its mind. General Motors said its earnings had almost doubled, and Kraft Foods announced a split as well as results that topped estimates - but these positives mattered little Thursday.¹

Of course, other recent news items were still on investors' minds: the disappointing U.S. GDP from the first and second quarters, the underwhelming July PMI readings from the Institute for Supply Management, the about-face in consumer spending in June, and the particularly poor showing of July's final Reuters/University of Michigan consumer sentiment survey.

Could we see a strong rally out of this position? Some market analysts thought a correction would take place this summer, with the major indices subsequently recovering in fall. Regardless of market reaction to Friday's jobs report, stocks could rebound, even before the holiday season.

At a time when bullish sentiment is being severely strained, it is worth accentuating the positive. Bloomberg data indicates that 77% of S&P 500 firms have surpassed average profit forecasts of analysts in this earnings period. The S&P 500 was trading for 13.8x reported earnings on the day before the correction - the cheapest level in 13 months. Birinyi Associates data notes that the average bull market since 1962 has lasted about 49 months (the current one is about half as old). In the past 39 years, 25 corrections have occurred in bull markets, and just 9 have led to bear markets; on average, these corrections have lasted 118 days. That is history, not the near future. Yet while the future is ultimately unknown, we can recall that last year's correction did not send Wall Street into a bear market.^{9,10}



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Citations.

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