In 2015, market volatility has been rooted in a phantom rate hike from the Federal Reserve, which throughout the year has been ringing a bell to warn markets that it is on the verge of raising interest rates for the first time since 2006. Though it hasn't happened, the Fed has elicited a typical Pavlovian response, causing markets to shudder at the thought and prompting a very significant chain of events that has rippled throughout global financial markets. While anticipation of the Fed's rate hike isn't the cause of market volatility, it has been a catalyst.

Tony Crescenzi, Pimco
Global Central Bank Focus, Sept. 2015

THE PROS AND CONS OF STOCK MARKET CORRECTIONS:

A stock market “correction” is when the stock market declines by at least 10% from its recent high. A “bear market” is when the stock market declines by at least 20% from its recent high. In the 3rd quarter, the stock market, as defined by the S&P 500 stock market index, dropped 12% from high to low. For the 3rd quarter as a whole the S&P 500 was down (-6.42%), and year-to-date through the end of the 3rd quarter the S&P 500 was down (-5.39%). Over half of the individual stocks in the S&P 500, as well as many stock market sectors, reached bear market territory during the quarter. It was the first real correction that investors have endured since August of 2011. Historically, stock market corrections occur on average every 357 trading days. Since we had not experienced a correction for almost 1000 days, it might have felt particularly perilous.

Let’s review some pros and cons:

1) **Pro**: Stock market corrections create new opportunities for purchases at lower prices, potentially increasing future returns.
   **Con**: Stock market corrections lower the current value of your existing stock market investments!

2) **Pro**: Stock market corrections are a speculation pressure relief valve. When asset values and collateral values drop, debt and leverage are exposed. Regular stock market corrections help keep excesses in check by regularly focusing attention on downside risks. Obviously corrections do not eliminate bear markets, but the “correction” euphemism (for a double-digit down market) does have some validity as an event that helps to correct or reduce excesses. At some level, corrections help the stock market stay healthier.
   **Con**: Stock market corrections lower the current value of your existing stock market investments!

3) **Pro**: Stock market corrections, and the downside volatility that stock market investors must endure, are one of the factors that drive superior returns versus risk-free investments over time. Or, short-term risk is the price you pay for long-term stock market returns. More risk on its own does not necessarily mean you will earn more return, but historically, prudent and diversified investments in the U.S. stock market have paid investors well for taking risk. On the risk-free or low risk side, a U.S. Treasury Bill or an FDIC insured CD doesn’t put you through much volatility on your monthly statement, but it doesn’t pay you much of a return either. (Determining how much risk is appropriate for you should be based on personal factors, such as income, assets, debts, needs, goals and time horizon).
   **Con**: Stock market corrections lower the current value of your existing stock market investments!

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The opening quote at the top of this letter is from a recent article by Tony Crescenzi at Pimco titled “In 2015, Volatility from a Phantom Rate Hike.” The topic of the article is the various market impacts of the ongoing Federal Reserve interest rate policy saga (note: Bill Gross, former Pimco Guru, and a regular read of mine whom I have often quoted, also had an excellent article recently from his new post at Janus Funds titled “Saved by Zero?” addressing a different side of the same topic). In a nutshell, as the Federal Reserve has gotten ever closer, incrementally leaning toward and purposefully intending to implement a ¼ of 1% interest rate hike up from 0%, the financial markets, in anticipation of a rate hike, were impacted by a chain of events that reverberated around the world and certainly played a role in our own stock market correction. In the article’s timeline, as the Federal Reserve’s language began to diverge from the other global central banks’ more dovish or accommodative monetary policies, the markets began to adjust currency valuations, resulting in a rapid, double-digit increase in the value of the U.S. dollar starting in the 4th quarter of 2014. From there, as Mr. Crescenzi states,

“The strengthening U.S. dollar and the anxious anticipation of a Fed rate hike by investors throughout the world sparked a cascade of events, all inextricably linked. One of these events has been a decline in commodity prices, which often fall when the dollar strengthens. The decline hurt markets in commodity-producing nations, including many in the emerging markets. Declines in commodity prices and attendant weakness in emerging markets has dominated markets this year, spilling over into developed markets by weakening equity markets, widening credit spreads and suppressing interest rates.”

The crescendo of events began on August 11th as China devalued its currency versus its implied dollar-pegged exchange rate by 3%. With a U.S. dollar peg, China’s currency had been appreciating along with the dollar at a time when the Chinese economy was weakening, the opposite of what would normally occur with a free floating currency. This created a “China-related feedback loop in global markets,” that, he concludes, has tightened financial conditions to the point that the Fed decided to delay its interest rate hike.

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From my perspective, a positive resolution to our current stock market correction will be based on the ability of the U.S. economy to navigate the current global slowdown and revive our recently fading consumer spending and corporate earnings. On the plus side, recent car sales, housing sales, bank loan volume and employment data all remain positive drivers. As I have written many times over the last couple of years, it is long past the time for the Federal Reserve’s policies to be in crisis mode. Even good intentions have negative and/or unintended consequences.

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WELCOME!

On behalf on everyone at Peak, I would like to extend a warm welcome to our new clients that have joined us from the October 1st merger of Ace Investing Services (Ace) into Peak Asset Management. We are thrilled to have Bob Cutler, CFP® (founder and principal of Ace) and Brent Yanagida, CFP® from Ace join us as managers, financial planners and members of our Investment Management Committee. Along with helping to facilitate the transition for Ace’s clients into Peak, Bob and Brent will provide additional sources of experience and knowledge to all of Peak’s clients. We are also grateful to have Leslie Cutler join us as a part of our transition team. We are committed to continuing to build on and improve the level and quality of services that we provide to all our clients, and to working hard every day to earn the trust you have placed in us.

Sincerely,
John McCorvie, CFA