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Anatomy of a Correction

It is tempting to attribute the recent weakness in the S&P 500 to current events (i.e. Ebola, ISIS, fears of Russian gas not being provided to Europe during the coming winter, etc.), but this most recent period of market weakness is arguably more a product of a process that began during the first quarter of this year. There has been a "cascading" and somewhat "hidden" erosion of the underpinnings of this year's U.S. major equity market advance that only recently became highly visible. The worst portion of the correction may have passed, and there is some evidence of building stabilization, but it is too early to give an "all clear" at this point, despite a strong rebound by many stock indices over the past few days.

Stage 1: Small Caps Faltered

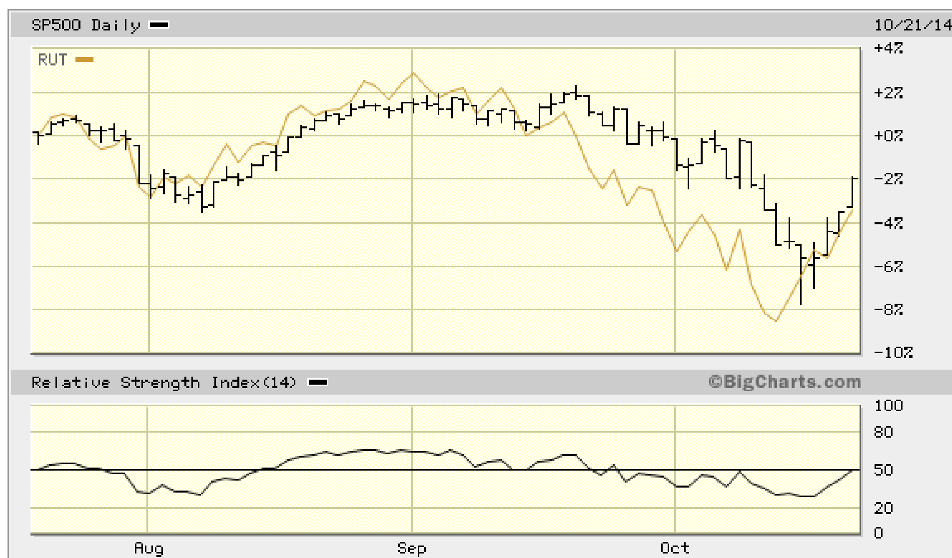
As you can see in the below 1-year chart comparing the S&P 500 with the Russell 2000 Small Cap Index, small cap stocks began to weaken relative to the S&P 500 in late March/early April:

They declined through mid/late May, but the S&P 500 continued its rise. In late May/early June, small caps tried to rally, but they weakened once again in early July. During this second period of small company stock

weakness, the S&P 500 Index showed some initial weakness in early August, but it quickly reversed and rose to a new highs later that month.

"Third Time's a Charm"

Small cap stocks tried to rally for a second time during August, but at the beginning of September they "rolled-over" for a third time, and unlike the prior two episodes, the S&P 500 followed the small cap index in almost perfect "lockstep". Over the past three months, the S&P 500 & the Russell 2000 index have been very highly correlated:



Stage 2: European Stocks Faltered

About 3 months after small cap stocks began their initial decline earlier this year, European stocks, especially those denominated in Euros, began to underperform the S&P 500. A large portion of that underperformance can be attributed to weakness in the Euro vs. the U.S. dollar:

1-Year Chart Comparing the S&P 500 Index vs. the Euro ETF (ticker: FXE; "blue" line) and the European Union Equity ETF (ticker: EZU; "yellow" line)

In the prior chart you can see that the Euro currency has started to show some stability and that the E.U. Equity ETF reversed direction at the same time as the S&P 500 began rising again last week.

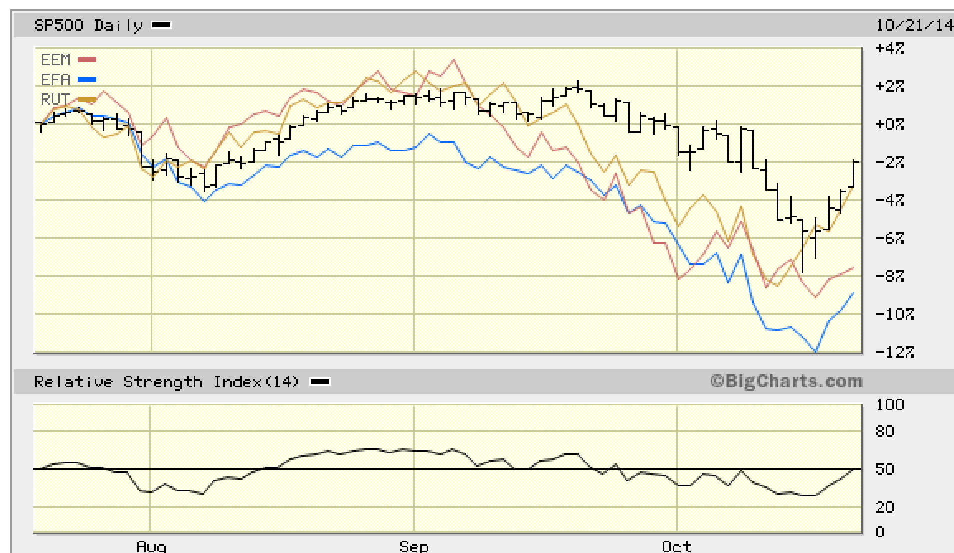
Stage 3: Emerging Market Stocks Faltered

Unlike small cap stocks/European equities that were strong performers in early 2014, but lost their strength as the year progressed, emerging market stocks (as represented by the Emerging Market ETF in the below chart; ticker: EEM; "yellow" line) were quite weak in January of this year:

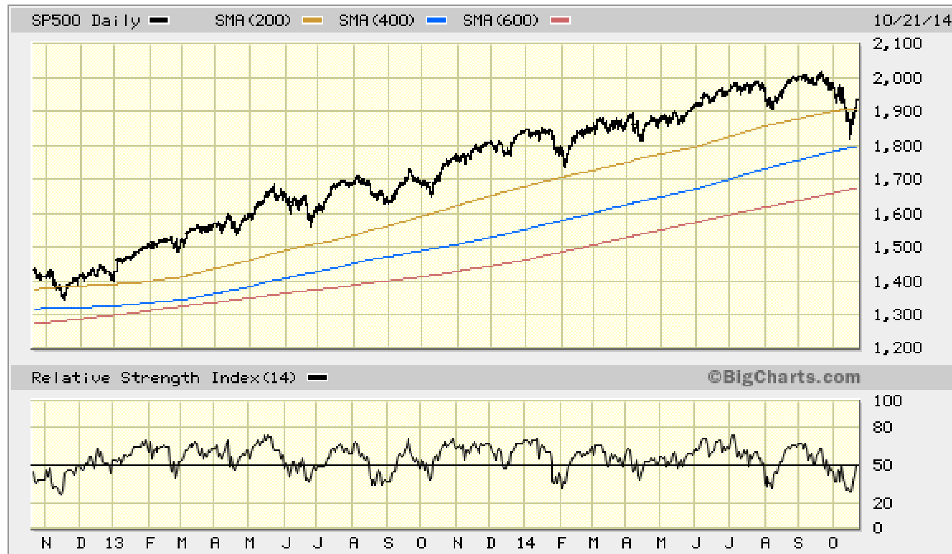
Beginning in early February, emerging market stocks began a very consistent rally that lasted until last month. The peak in the Emerging Market ETF occurred a couple of weeks before the peak in the S&P 500.

Stage 4: A Synchronized Global Correction in Equities

Over the past 5-7 weeks, most of the major constituents of the global equity market have succumbed to significant weakness and have corrected 8-14% in price terms. These are represented by the S&P 500, Russell 2000, EAFE ETF (developed, non U.S. equity index) and Emerging Market ETF in the below chart:



In the past few trading sessions, we have seen all of these equity market indicators make a sharp reversal. While encouraging, an insufficient amount of time has passed to have great confidence that this correction period has run its course. Further, while the S&P has pulled back sharply, the correction has not been deep enough, and/or prolonged enough, to have truly addressed the "overbought condition" (i.e. "too far, too fast") that resulted from the index's almost uninterrupted advance over the past 23 months:

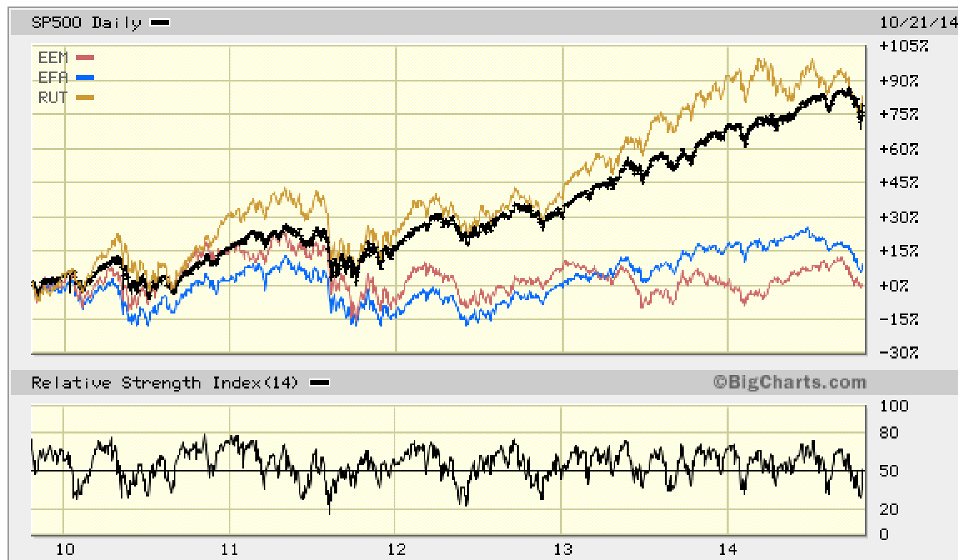


The S&P 500 almost reached the 1,800 level last week. If the S&P 500 "re-tests" that level, especially with a new low closer to 1,700, and/or it trades below 1,900 for several weeks, greater confidence can be placed in the notion that the overbought condition has been more fully addressed. Even with the sharp pullback of the equity markets, combined with Ebola outbreak fears, investor confidence has not been dampened as significantly as one might expect (as indicated by a variety of investor sentiment indicators). In addition, the bulk of the third quarter earnings reporting season remains to unfold and the results thus far have been mixed with severe responses in those cases where results were disappointing (i.e. IBM and Microchip Technologies; both down over 10% after reporting results) and more muted responses where results were quite good (i.e. Apple and Alcoa; both up less than 5% after reporting results).

Stage 5: A Synchronized Global Recovery with New Leadership

For about two years we have commented on the prospect for a synchronized, global, economic recovery. We first described it as an "ugly" economic recovery and then several months ago we upgraded it to "semi-pretty". By next spring we expect to be justified, to once again, upgrade the description to "attractive". Along with this potential outcome will likely be the emergence of new leadership in the global equity markets. For the past 5 years the S&P 500 & Russell 2000 indices have outperformed developed non U.S. and emerging market equities by about 60-75%: (see chart on next page)

5-Year Chart Showing the Outperformance of U.S. Equity Indices (S&P 500 & Russell 2000) vs. Non U.S. Equity Indices (EAFE & Emerging Markets)

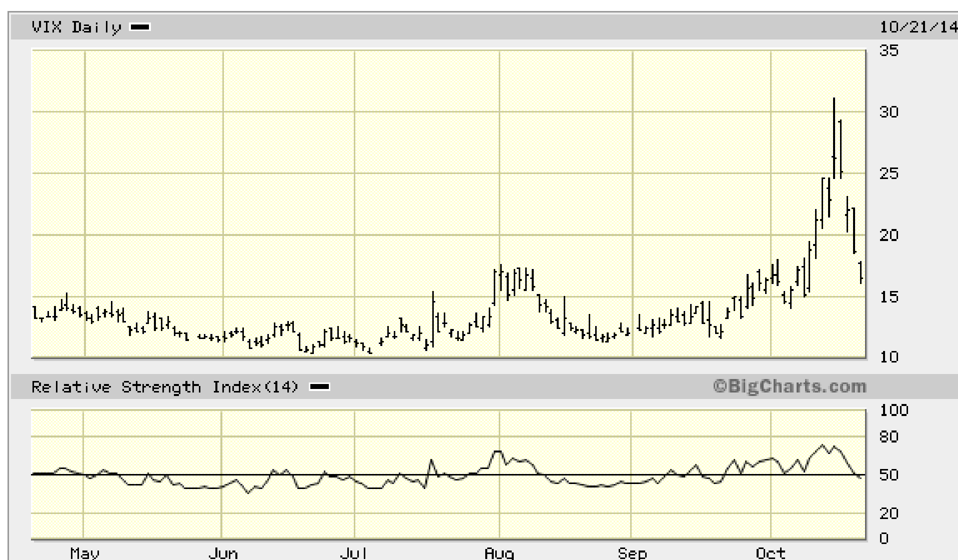


Over the course of the next 3-5 years, we are likely to see this relationship reverse with the S&P underperforming non U.S. equity markets in a substantial way as our economic expansion ages and the Federal Reserve continues to reduce/withdraw stimulus; ultimately resorting to a restrictive policy. Conversely, Europe, Japan and the emerging markets are just starting to emerge from their economic weakness, their central bank authorities are still exploring avenues to increase economic stimulus and their efforts to reduce stimulus are at least a couple years behind our Federal Reserve's recent "tapering" efforts.

Strategy Implications

We successfully increased our VIX volatility index exposure during the summer months and exited our positions at favorable prices during the recent spike in volatility:

6-Month Chart of the VIX Volatility Index



In conjunction with exiting our VIX Index ETF positions, we lowered the sensitivity of the hedging strategy to better benefit from an eventual stock market rebound, but not to a level so low as to render the strategy incapable of providing the potential for substantial risk mitigation if there is indeed a continuation of this corrective period.

In addition, we have been trimming our overweight positions in more volatile investments and reallocating those proceeds into more diversified investments (i.e. some single country/region ETFs have been reallocated into global equity ETFs; more narrowly-focused industry ETFs, such as homebuilders, into broader sector ETFs such as healthcare/technology). The purpose of this approach is two-fold: 1) reduce the volatility of our "risk assets" during this period of heightened volatility; and 2) increase the correlation between our "risk assets" and the tools we use within our hedging strategy resulting in a decrease in overall risk. We look forward to seeing further evidence that this period of equity market weakness has passed and that confidence has returned/been reestablished with regards to continued economic growth, both here and abroad. The remainder of a thus far "mixed" earnings reporting season, the tenuous reduction in hostilities between Russia and Ukraine as we enter the winter season, the upcoming national election run-off in Brazil and the anxiety over the sufficiency of our government's response to the Ebola threat are all potential sources of concern and volatility, but we remain committed and prepared to take advantage of the events as they unfold whether in accordance with our longer-term outlook for increased prosperity, or the shorter-term reality of turmoil and uncertainty.

"Look to the Future, be Optimistic…but Hedge."

(We want to keep these commentaries brief and focused so as to provide a good "information-to-text-length ratio", but if you have specific questions/topics you want me to address, please let us know.)

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