Chapel Hill Investment Analysts, Inc.
Financial Planning • Investment Management

"Cup of Joe"



With the markets now in correction territory, we wanted to put things into perspective so that everyone has an idea of what's going on. First, a correction means that the market has declined more than 10%. On average, the market corrects every 18 months. The stock market has not corrected in over 4 years, so we were way overdue. Are market corrections normal? YES! Although painful to watch, this is a healthy way for markets to keep going higher. When markets become "frothy", overvalued, overbought etc. stocks need to sell off to maintain their true value (the price of buying the stock does not make sense...it costs too much for the potential return). With asymmetrical moves higher and higher with no pullback, the stock just keeps getting more and more expensive and this is what leads to steep declines. A correction brings the price per share back down to a realistic value where people want to buy it again. The market will drop until there are no more sellers and bargain prices attract motivated buyers to jump back in. Corrections almost always have a catalyst as well. In October, even though it wasn't technically a correction, people thought the world was ending due to Ebola. This had nothing to do with the decline, in retrospect, but that is what made the headlines. Now, the new catalyst is China. Sometimes the catalyst is a lot scarier. But remember, if it were not scary, no one would sell! This time the slowing Chinese economy brought into question the potential impact on the world economies. Although China is playing a large part in this correction, I think there is a perfect storm of sorts contributing to the negative data floating around and now adding additional fear in the minds of investors.

My opinion on China is that the devaluation was a little overblown and that the slowdown of growth has been telegraphed for a long time. China's goal for a while now has been to create a more normalized economic machine, relying on domestic consumption to drive growth whereas before, growth was created by government investment. Obviously, this is a huge endeavor, one that takes time and comes with the normal growing pains along the way. But, let me highlight this once again. THIS WAS A TELEGRAPHED MOVE! The Chinese needed to do this or run the risk of overheating and causing bigger problems down the road. Maintaining a 7% GDP growth was never going to be sustainable. The economies around the world have been reliant on the Chinese growth for years and all of the sudden, reality has sunk in. Their security blanket has been taken away. Who will be the next global driver of growth??? The U.S.A.! And one last positive note on China: they have over a billion people who are slowly coming into a more normalized consumption based economy. This has the potential to be a huge economic driver for many years, but it has to be managed properly. From a market perspective, the decline in the Chinese markets was bad. But, only 10% of the people of mainland China were invested, and heavily leveraged to boot. That leaves 90% of the people who are not yet invested in the system. That is a lot of growth potential if you ask me.

The next contributor to the perfect storm is oil. And, yes, it is taking a bath once again, primarily due to the feared slowdown with China. But consider Iran's pledge to release the motherload of oil on the world markets. This only adds to the existing glut of oil, thus suppressing prices even more. Again, this is a double-edged sword. This will hurt the energy sector but help the consumer. In the end, big oil will prevail. Consolidation will take place as the big companies (ie. Exxon) buy up the little

guys. And the market will become more reliant on a more normalized supply and demand driven system. Let me reiterate, though, that we feel that the oil decline is not demand-driven, meaning it's not caused by the slowing of the world economies. Rather, it's an effect of the oversupply of oil caused by OPEC trying to snuff out the U.S. Shale producers and crush Iran's future profits.

Lastly, the fear of rates rising has been discussed in detail over the last couple of email updates. When rates rise, it will be slow and concise. It will spook some, but a more normal monetary system is good for everyone. This also equates to a stronger economy.

Large declines in the market have the tendency to scare people, causing what is called capitulation, or "fear selling". This is when people just throw in the towel and give up any gains they may have had to just get out of the market. When the market declines, the only time you lose money is when you sell. Since 95% of the population do not have financial advisers (no one to call when they get worried), many let the fear get the best of them, panic, and sell when the market is at the bottom. This locks in their losses. Then, because of fear again, they never re-enter the market and eventually buy in when it's high. This is textbook "what not to do" when investing. If I had a guess, Warren Buffet is not selling now. I would bet he is buying with both hands. Long-term investing means that you understand that statistically, a human being CANNOT time the market - you can't fight statistics. You have to come to terms with the fact that this stuff happens. The market goes up and the market goes down. But fundamentally, the economy is getting stronger every day. Chipotle just announced its hiring 4000 new employees. They see a shortage of restaurant workers and want to beat the competition to the punch (good news for the college kids). The unemployment rate is at 5.3%; rates are at historic lows; Europe and Japan are stimulating their economies; and energy prices are in the tank, giving consumers more money in their pockets. And comparing today to two weeks ago, nothing really changed. Sometimes the market acts funny. This is just one of those times. From a valuation standpoint, the pundits on TV are saying how overpriced everything is in relation to historical averages. The one part they are missing…interest rates. Rates are historically low. And in relation to a 10 year treasury paying 2%, stocks look pretty good in terms of risk versus reward.

Moving forward, the market may get worse before it gets better. But corrections end and the economy will continue to grow. From a common sense perspective, think about this for a second: if banks pay nothing and bonds will lose money when rates rise, where else are people going to put their money? They can't sit in cash forever (they will end up just spending their principal until they are broke). The market hasn't been this range bound as it has been over the past 6 months in over 90 years. Think about that statistic for a second -- 90 years!!! Well, if no money has been invested in the market and people have kept on working, where is all of the money sitting? My guess is on the sidelines waiting to go in. It may not be tomorrow, and it may not be next week, but the money will come roaring back in at some point and the only viable alternative is the market.

Our advice is to sit tight and have your eyes on the big picture. Instead of looking at a chart of the last month, look at a chart of the last 6 years. This market correction looks like a tiny squiggle in relation to the bigger charts. One can't time the market. No one knows when these corrections are coming. But what you can do is be smart, stay positive, and remain calm in times of volatility. This won't be the last correction! My Dad likes to count the number of corrections that he has navigated over the last 34 years, as most of you will recall. But we feel things are going to turn around, and when they do, you will be there with a well-diversified portfolio and a team to help guide you to a prosperous future.

CONTACT US

jsc@chapelhillinvestment.com

rmc@chapelhillinvestment.com



*Please note, if the link is not highlighted, copy and paste the address in your navigation bar.

SHARE THESE LINKS:

http://www.businessinsider.com/facts-about-10-corrections-in-sp-500-2015-8

follow on Twitter | friend on Facebook | forward to a friend

Copyright © 2015 Chapel Hill Investment Analysts Inc., All rights reserved.