CAPITAL ADVISORS

Market Comment
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Recent Stock Market Drop: Opportunity or Something More Troubling?

Global stock markets have experienced a sharp downdraft in the last three trading sessions, with the *S&P 500 Index* and the *Dow Jones Industrial Average* slumping 5.23% to 5.12%, respectively. Futures markets indicate there will be further downside today. The recent pull-back has likely been prompted by an increasingly pessimistic outlook for the Chinese economy. Until last week, investors outside of China shrugged off negative data from the world's second largest economy, including a steep bear market in the *Chinese Shanghai* and *Shenzhen* stock markets, slowing economic growth, declining exports, and the recent devaluation of the Chinese yuan. However, late last week the release of the *Caixin/Markit China Manufacturing Purchasing Managers' Index (PMI)* showed its manufacturing sector declined at the fastest rate in over six years. This data point seemed to be the straw the broke the camel's back, as the *Chinese Shanghai* market fell 4.3% on Friday, and more than 8% overnight. Global markets have followed suite. Investors seem to have reached a tipping point of concern about the health of the global economy due to China's outsize contribution to global growth in the years since the financial crisis.

We believe the current pull-back will not evolve into a bear market for the U.S. stock market, as the domestic economy continues to expand, albeit a tepid pace. Stock market declines of 5% to 10% are quite normal, and usually occur every year or two. The past four years have been unusual in that the *S&P 500 Index* has not experienced a 10% correction since 2011. With the *Dow Jones Industrial Average* off approximately 10% from its May high, and the *S&P 500* down 7.5% (plus whatever happens today), we would not be surprised to see further weakness in the near-term. However, we do not see the warning signs (recessionary data, falling profits, elevated credit spreads, etc.) for a deeper sell-off of 20% or more, which is the common threshold for a "bear market."

We acknowledge that China's economic situation is concerning, but so far the impact on the U.S. economy has been manageable. One reason we expect this can continue is because exports to China account for less than 1% of U.S. gross domestic product (*source: Bank Credit Analyst BCA*). Indeed, since China exports far more than it imports, a slowdown in China may not have the same ripple effects that a more balanced economy might trigger. According to *BCA* research, exports to China account for less than 1% of GDP for the U.K., France, Italy and Spain, 2.6% for Germany, and 2.7% for Japan. We will be watching global economic data closely for signs of a broader decline, and should we see evidence of something more ominous, we will look to reduce risk further.

As a reminder, we track a number of quantitative indicators to complement our overall investment strategy, including monitoring behavior in the fixed income markets. We track changes in the corporate bond market for insight into the overall risk climate in the asset markets. Thus far, the indicators we watch suggest stocks are probably experiencing a normal correction, rather than the start of a something more sinister.

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The primary risk indicator we track is called a "credit spread." It measures the difference in yield between risky corporate bonds and U.S. Treasuries. The yield premium that investors demand for holding sub-investment grade "junk" bonds relative to U.S. Treasuries offers an objective measure of the overall risk climate in the economy. Historically, when the spread between these two credit market benchmarks has been low and stable, asset markets have been stable too. However, when the yield spread between junk bonds and Treasuries jumps higher, trouble has frequently followed.

Widening credit spreads have paralleled the recent pullback in U.S. stocks since May. The chart below tracks the daily yield spread between a widely followed junk bond index and the 10-year U.S. Treasury. The average spread over this 17-year time period (daily average 12/31/96 to 8/20/15) has been 5.79%, right in line with the recent level of 5.75%. Although the current spread is in line with the historical average, we would note that credit spreads have been rising over the last month, so this bears watching.

Historically, credit spreads have expanded immediately before, and during recessions, as shown in the above chart (recessionary periods are shaded). Markets have also experienced brief periods of rising credit spreads associated with unpleasant surprises outside of the U.S., like the 1998 "Asian Currency Contagion," the onset of the Iraq war in 2003, and the onset of the euro zone debt crisis in 2011. None of these events triggered a bear market in the U.S., however, because in each case the domestic economy avoided a recession. We do not expect a recession to follow the current upward drift in credit spreads based on the evidence available so far in the economic data, and in the recent performance of corporate sales and profits.

Although we're not expecting a bear market, we do not intend to increase the risk profile of our investment strategies materially. Rather, we hope to use the recent pull-back to build new positions within our managed equity strategies, while simultaneously reducing, or eliminating stocks that look less compelling in comparison to some of the new opportunities that have emerged from the downturn.

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S&P 500 Index is a market capitalization-weighted stock market index comprised of the largest companies in the U.S. stock market. It seeks to measure the broad performance of the domestic equity market.

Caixin/Markit China Manufacturing Purchasing Managers' Index (PMI) is a monthly survey of purchasing managers throughout China. It seeks to reflect business activity levels in the economy.

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