



## You Can't Time an Equity Correction, but You Can Prepare

An equity correction in the U.S. markets, according to the technical definition, which states that a correction is a reverse price movement of at least 10% to adjust for overvaluation, last occurred (using the S&P 500) between November 2015 and February 2016 (see table 1). There is plenty of literature in circulation describing why or why not the market is now heading towards its next correction and frankly, trying to accurately time such an event is, in our opinion, a futile exercise, but what we would like to suggest is what an investor might consider in terms of their balanced portfolio in an effort to prepare for, and then benefit from, the inevitability of a correction.

To begin, we'll suggest a few scenarios which may become the cause or one of the factors that ignite an eventual correction. As is observable from Chart 1, the CBOE volatility index (VIX) or the "fear index" has been on a downward trajectory. Since the presidential election in November when the VIX hit \$21, it has gradually fallen despite much of the economic and political uncertainty that exists globally.

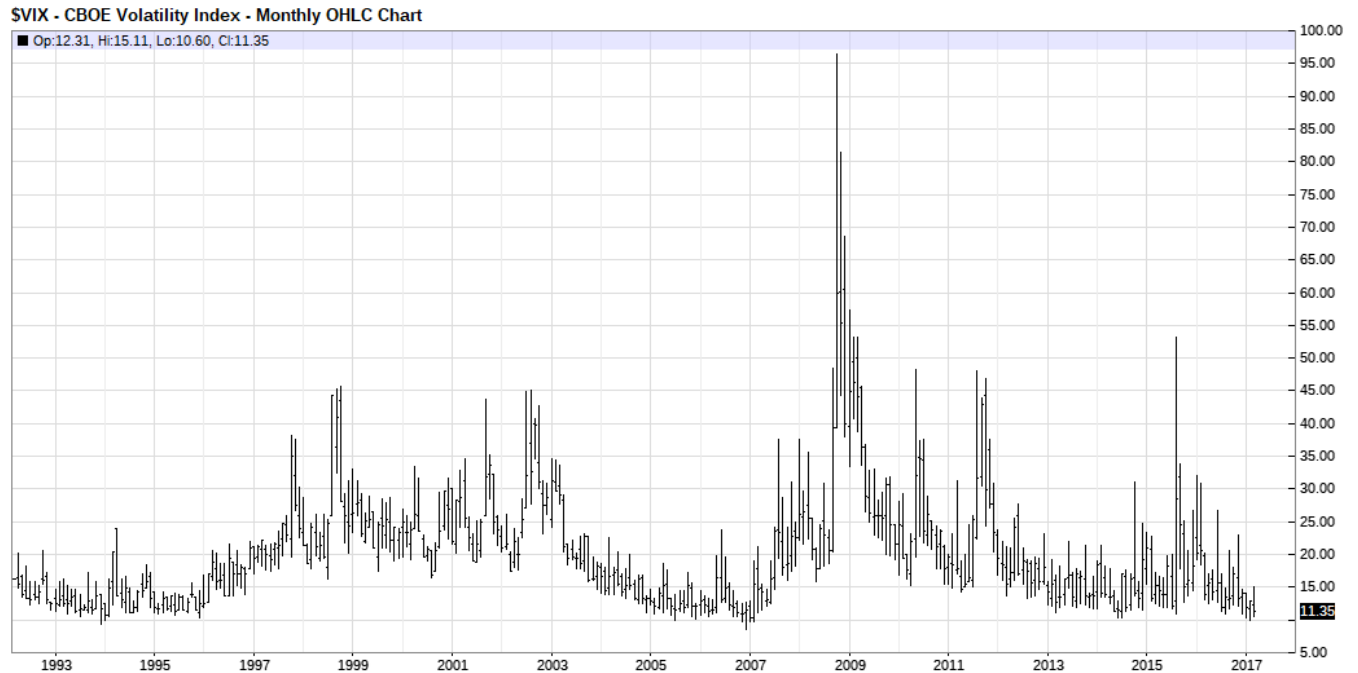
Table 1

**S&P 500 Corrections & Bear Markets Since 1928**

Beginning	End	Peak Price	Trough Price	% Δ Peak to Trough	Length
2/13/1980	3/27/1980	118.44	98.22	-17.07%	43
11/28/1980	8/12/1982	140.52	102.42	-27.11%	622
10/10/1983	7/24/1984	172.65	147.82	-14.38%	288
8/25/1987	12/4/1987	336.77	223.92	-33.51%	101
7/16/1990	10/11/1990	368.95	295.46	-19.92%	87
7/17/1998	8/31/1998	1186.75	957.28	-19.34%	45
3/24/2000	10/9/2002	1527.46	776.76	-49.15%	929
11/27/2002	3/11/2003	938.87	800.73	-14.71%	104
10/9/2007	3/9/2009	1565.15	676.53	-56.78%	517
4/23/2010	7/2/2010	1217.28	1022.58	-15.99%	70
4/29/2011	10/3/2011	1363.61	1099.23	-19.39%	157
5/21/2015	8/25/2015	2130.82	1867.61	-12.35%	96
11/3/2015	2/11/2016	2109.79	1829.08	-13.31%	100

Source: <https://www.yardeni.com/pub/sp500corrbeartables.pdf>

Chart 1



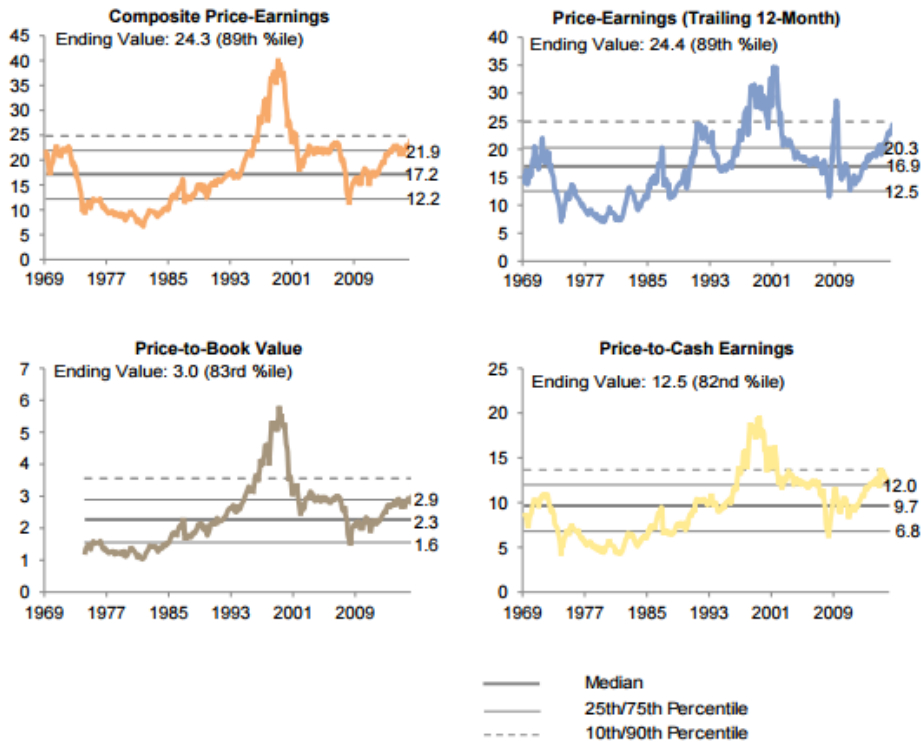
Source: Bloomberg

A low VIX tends to suggest an optimistic and complacent market, as if investors believe they have the world figured out. The equity market has had an impressive run of late, which could be related to the “Trump trade”, while there’s also the theory that Federal Reserve chairwoman Janet Yellen’s expression of confidence in the U.S. economy created the rally or that the credit should go to the economic rebound on former President Obama’s watch, nevertheless there are headwinds on the horizon. Thus far President Trump has struggled to achieve anything from his ambitious agenda and his approval ratings have dropped. Whether he is able to pass a tax reform bill and the regulation reductions he’s promised has yet to be seen. Furthermore, U.S. equity valuations range between fair to overvalued (see Chart 2), Brexit Article 50 has been triggered, a number of influential European countries are in the midst of controversial elections and many parts of the global trade network are in limbo, to name a few outstanding items creating uncertainty. Additionally, there are the effects of a rate hike cycle on stocks, which the Fed is pursuing in response to low unemployment figures and inflation concerns. Typically, rising rates are not favorable for stocks (aside from a sector such as finance). When rates rise, borrowing costs increase, which translates into less discretionary spending by consumers and fewer corporations issuing debt. If companies are spending less or paying more towards interest costs, less revenue is generated, estimated future cash flows drop and stock prices come down. Again, we are not making any predictions about the timing, as there is always another side to the argument and the S&P 500 just closed the first quarter of 2017 at a high not seen since 2015.

Chart 2

**MSCI United States Index Valuations**

December 31, 1969 – February 28, 2017



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Another point to highlight relates to the Dow Jones Industrial Average (DJIA). Though the above paragraphs have focused on the S&P 500 Index, as we believe this index is the most accurate and comprehensive representation of the U.S. equity market, to many investors, especially among the retail community, the DJIA has become a psychological indicator. For a typical retail investor “the Dow” equates to the stock market in its entirety. Therefore, the historic significance of an index move beyond the 20,000 mark, which occurred on January 25, 2017, is material. More specifically, it means that a 10% correction is an approximate 2,000 point drop, which to many U.S. investors may become a mental destabilizer. Again, we are not trying to predict when this might happen or exactly how the traditional retail investor will ultimately respond, but we do want to make aware the importance of a 2,000 point drop. The media will likely publicize this event vigorously and there is a possibility that those who pull out of the market during such a period may prolong a market rebound given the likelihood that their money will linger on the sidelines longer than it has in past corrections.

We believe that at this point in the cycle, the downside risks are higher than what is achievable on the upside in the U.S. equity market. Therefore, we are of the opinion that balanced portfolio investors should consider increasing their cash allocation slightly by reducing some of their U.S. equity exposure. Typically, we might suggest cash or cash equivalent investments of approximate 5%, while today we



are recommending an increase of 3-4% from a portfolio's current cash level. We would then suggest that an investor/advisor monitor the VIX index and reinvest that capital once the index has surpassed \$25. At that point, we would expect the market to have dropped considerably, offering an attractive entry price.

Date: April 2017