Market Update: 1/26/2014
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Something funny has happened on the way into 2014…..the stock market has gone down. Not funny, ha ha, though. Funny like, uncomfortable. You know, the way kids describe feelings to which they are unaccustomed. And coming out of a year that lacked substantive fear, volatility and measurable decline, it is understandable to be unaccustomed to underachievement.

However, it is not funny to speculate as to why this pull-back (the S&P 500 is down 3.1% and the Dow Jones Industrial Average is down 4.2% thru Friday[1]) has happened and what it portends? Being cautious not to see mountains where molehills exist, we offer the following:

There are a few primary culprits for the market's recent weakness. The first actually stems from a group of foreign countries known colloquially as the "emerging markets." These include such nations as: Brazil, India, Venezuela, Turkey and Argentina among others. The emergent distinction is attributable to their developing socioeconomic status and capital market access infancy (aka – they have smaller, diverse bases of gross domestic product with short histories of accepting outside investor monies) equating to the perception of them as higher-risk propositions.

The emerging market countries had been beneficiaries of US monetary policy since 2008. It was then that the Federal Reserve Bank began rapidly and dramatically driving down interest rates. They did so by injecting gargantuan gobs of cash into the monetary system via multiple fancy-titled bond buying initiatives. The goal of the gobs was to entice corporations and individuals to invest and spend – compelling confidence in the wake of the credit crisis.

And much of that investing and spending went straight into the emerging market countries; their stock and bond markets. Adhering to the axiom that higher risk begets higher rewards, cheap US dollars sought enhanced returns in emerging markets – those that were less directly impacted by the mortgage mess and offered outsized opportunities.

This Fed policy directive persisted until just recently. Last month, in Ben Bernanke's penultimate meeting as Chairman, the Fed followed through on an early-summer threat to "taper" the magnitude of its bond buying. The outcome was a delicate reduction of available liquidity. The impetus was a palpable improvement in the domestic economy. The Fed implored the markets to construe this constructively – the foundation is firming, lessening the need for synthetic stimulation.

However, reaction in the emerging countries has been anything but delicate or constructive. Investments are repatriating to the US, hurting the emerging stock and bond markets and the currencies of the countries that had come to rely upon a perpetually ultra-accommodative Fed.

The currencies that have been hit the hardest are:

- those countries with high inflation rates;
- those that need to raise outside capital to fund their current account deficits;
- those that have high levels of geopolitical instability.

Bear in mind also that one of the most attractive features of these emerging economies is their base of natural resources used as raw materials in global manufacturing. The negative feedback loop of more expensive money combines less demand with higher prices in their home currencies - certainly enough to send a ripple through global markets.

So investors were content to move money out of countries they view as riskier, as higher returns are more enigmatical as the sands of monetary policy shift more tightly.

Another item that deserves some attribution of the market's tough start this year is the heightened worry about the ongoing strength of the Chinese economy. It is very much expected that the Chinese government will unveil an economic growth target of 7.5%[2] in March. But it was entirely unexpected that the country's factory sector would post a contractionary reading this past Thursday[3].

As mentioned in the footnoted article above:

> *' "Such a reading highlights the deteriorating growth outlook as policymakers are tightening their monetary stance, pushing through with an austerity campaign, and withdrawing stimulus measures," said Dariusz Kowalczyk, a senior economist and strategist for Credit Agricole CIB in Hong Kong.'*

For at least the last decade, China has been a steady source of demand for the world's natural resources and an insatiable consumer of Westernized imports. An indication of a premature dissipation of either will be critical to recalibrating global economic growth. That process, like any surreptitiously strewn upon the markets, is bound to be dogged by dislocation.

To recap so far: fear has elevated overseas due to the emerging market indigestion of global liquidity contraction and Chinese economic ambiguity.

Oh, and there is one more thing – right here on our home soil: US corporate profit growth and outlook has been only a little better than OK. According to Friday's Money News[4]:

> *"About two-thirds of the 123 S&P 500 companies that have reported fourth-quarter earnings so far have beaten analysts' estimates, according to S&P Capital IQ, in line with the historical average. But the forecasts for income growth have been falling and could decline further.*
>
> *As recently as this summer, analysts predicted earnings growth of more than 11 percent for the fourth quarter, but now they expect just half that — 5.9 percent."*

Given the characterization of the stock market as a, "forward-looking mechanism that discounts the future into current prices," the heady gains of 2013 are looking for corroboration by the underlying economy upon which those gains were gotten. In absence of clear and present confirmation, the market is understandably a bit temperamental.

So we are dealing with an early-year pull-back, and like pull-backs any time of year, it is not fun. Understand however, that a contraction of 3-4% is unique only in its near-term absence and is historically unremarkable.

It has been over 27 months since the last market "correction," which is defined as a decline of 10% from its starting point. It is obviously inconclusive whether the start to this year elevates to that classification but this week contains some catalyzing events that a hungry market is sure to feast upon. Of note:

- A 2-Day Fed meeting on Tuesday and Wednesday;
- Corporate earnings by over 75 companies in the S&P 500;
- The State of the Union Speech;
- Multiple addresses by emerging market leaders on the state of their fiscal affairs;
- And of course, the Super Bowl on Sunday.

Never one to dismiss superstition, the beloved *Super Bowl Indicator of the Stock Market* indicates, with an 80% accuracy rate[5], that if the team from the NFC wins the Lombardi Trophy; the stock market will be positive for the year.

So, on that note I'll let you know that we will keep in close touch in dissecting the market's meanderings and obviously, GO SEAHAWKS!

I hope you've had a great weekend! dc

[1] Source: Bloomberg Market Data
[2] http://online.wsj.com/news/articles/SB10001424052702304757004579331422321628250
[3] http://www.reuters.com/article/2014/01/23/us-china-economy-pmi-idUSBREA0M04420140123
[4] http://www.moneynews.com/StreetTalk/Wall-Street-stocks-Dow-DJIA-markets/2014/01/24/id/548833
[5] http://www.investopedia.com/terms/s/superbowlindicator.asp

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