Droms Strauss Wealth Management

Special Market Communiqué

August 25, 2015

With all of the major stock market averages closing down again today (DJIA and S&P 500 both down 1.3%, and the NASDAQ down 0.5%), we are experiencing a striking level of market volatility. All three market indexes began the day with strong rallies only to run out of steam in mid-afternoon and turn sharply downward. During these very difficult markets, it is more important than ever for all of us to sit back and digest what happened and what the implications are for our investment strategy going forward.

As of the end of last week, the Dow Jones Industrial Averages closed down by 5.8%, from 17,477 on Friday the 14th to 16,460 on Friday the 21st. The Dow entered correction territory, having dropped by slightly more than 10% between its last high in May of this year and last Friday. The S&P 500 and NASDAQ also were down sharply last week, but had not yet entered correction territory. The carnage continued on Monday, with the Dow dropping over 1,000 points in early trading, then closing down 589 points (-3.6%) at 15,871. With yesterday's decline the S&P 500 and NASDAQ both entered correction territory with the S&P down another 78 points (-4.0%) to 1,893 and the NASDAQ down 3.8% to 4,526. Today's milder market declines continue the negative trend in the major equity markets and we can almost certainly expect to see more volatility ahead.

One ray of optimism amidst all of the extreme volatility is to look back at the stock market crash of 2008-09, when the S&P 500 Index bottomed at 676.53 on March 9, 2009. At today's closing level of 1,868, the S&P is 176% higher than it was just 6½ years ago. We also have to consider that markets never go straight up, so occasional corrections are inevitable and for those of us with "weaker stomachs" living through them is part of the price paid for the higher long-term returns earned in the equity markets. For those of us with a higher tolerance for market volatility, declines such as we are currently experiencing can be viewed as an opportunity for those of us with investable cash. Just since 2009 there have been twenty 5% declines, four 10% declines, two 15% declines and one 20% decline. In hindsight, every one of those corrections proved to be a good buying opportunity. For those with stronger stomachs and available cash to invest, you may even want to consider talking to one of us about taking advantage of this recent decline in the market.

Much of Monday's sharp downturn was precipitated by the continued rout of the Chinese stock market: the Shanghai Stock Index was down 12% last week, fell another

8.5% yesterday and lost an additional 7.6% today. Plunging stock values and concerns over the impact of slowing economic growth in China on the rest of the world appear to present the biggest concern pushing global equities down. The Chinese government is maintaining its 7% growth outlook, but few analysts take this figure at face value. Independent estimates point to China's growth range down anywhere from 6.3% to much lower. To offer some perspective, it is worthwhile to note that U.S. exports to China comprise less than 1% of U.S. GDP and European exports less than 2% of European GDP, so the fear gauge may be a little too high on this issue.

The second biggest concern is the potential increase in interest rates in the U.S at the next Fed meeting on September 16-17. Even though a rate increase seems much less certain than it did just a few weeks ago, and the raise, if any, will almost certainly be no more than 0.25% following six years of zero interest rates, investors are concerned about the impact of even a small rate increase on economic growth. Finally, the continuing strengthening of the U.S. dollar makes U.S. goods more expensive overseas and may create a significant drag on the U.S. economy.

Other lesser worries also abound, including concerns about how strong reported quarterly earnings will come in when reporting season starts in late September. The uncertain economic outlook and strong dollar may combine to create a drag on earnings. And, of course, the uncertain political environment, including the current disagreements about the pending deal with Iran and North Korea's continuing saber rattling also weigh on the investment outlook.

The logical question for all of us, of course, is "what should we do in response to global slump in stocks over the past several days?" This Saturday's Wall Street Journal sent us a valuable gift in the form of Jason's Zweig's column on page 1 of the Business and Finance section, entitled "What investors shouldn't do now." Among other things, Zweig points out that although stocks currently are "not cheap, they aren't wildly overpriced, given today's levels of interest rate and inflation." He points out that the Shiller Index, a popular measure of the ratio of stock prices to their 10-year, inflation adjusted earnings, currently stands at 24.9 compared to the last 30-year average of 23.8, fully priced but not grossly overpriced. He also points out, that that neither "you – or anyone else – knows what will happen next" and that "diversification, patience and, above all, self-knowledge are your best weapons against this irreducible uncertainty."

Zweig's advice coincides with the investment approach we have been applying for our investors for the past 21 years. Our answer to dealing with market volatility does not change from year to year or month to month: asset allocation is the key to long-term investment success. We all need to settle on an asset allocation appropriate to our risk tolerance and learn to live with the inevitable volatility. If the volatility becomes too much for our risk tolerance, then making a permanent change in our asset allocation may make sense. If you think a change in your long-term asset allocation might make sense for you, please call us to review your investment strategy.

As you know, we do not try to time the market by doing short-term in and out trading based on predictions of where the market is going next. We have seen enough data and been at this long enough that we are convinced that short-term market timing is much more likely to lead to long-term losses than to actually protect a portfolio. All of the data we have seen indicate that successful short-term trading requires a predictive accuracy of at least 70 percent, and that level of accuracy is just not likely. The recent increase in volatility makes this type of approach even more difficult.

After last several days of market volatility, it is useful to consider that, over the long haul, the stock market reflects the future of the economy. Looking at current data, we can see that unemployment is easing, inflation is nearly non-existent, interest rates are low, and the economy is growing. Also, at current P/E ratios, the major stock indexes are nowhere near overpriced: according to J.P. Morgan's chief economist, Dr. David Kelly, the forward P/E of the S&P 500 at the close Monday was 15.2 compared to the 25-year average of 15.7. This is not a recipe for a major disaster. The way we look at the world of investing is to try to assess where the economy and the market will be two to three years out and we expect that we will see positive returns over the next two to three years. Hence we believe it makes good sense to remain invested in equities.

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