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Reintroducing Volatility

Understanding the Roots of an Overdue Correction

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On Feb. 27, we saw the reintroduction of volatility in the global equity markets, something we hadn't seen for quite a while. This caused a dramatic interruption of the steady upward progression of world equity markets. The S&P 500, for example, suffered its biggest one-day fall since reopening after the Sept. 11 terrorist attacks.

Does this volatility signal the end of the reign of equities, the start of a global economic recession, or is it just a blip on the radar screen

of an otherwise healthy global economy? In order to understand, it is important to look at the volatility in context.

Market Correction Overdue

The U.S. bull market, which began on Oct. 9, 2002, had matured into the second longest since World War II. The S&P 500 appreciated 88% from its trough, and this advance hadn't been interrupted by any major pullbacks. Neither the S&P 500 nor the Dow Jones Industrial Average,

for example, had fallen as much as 2% from a high since last summer.

Because of this, market sentiment — the collective bias of traders and investors — had become complacently bullish, which skewed the distribution of investment positions. This situation is inherently unstable and can correct for any plausible reason, sometimes for no apparent reason at all.

Many catalysts for the sell-off and the change in investor sentiment have been proposed. These catalysts include:

- The brief but significant decline in Chinese stock markets on February 27.
- The potential unwinding of the yen “carry trade,” which may lead to the forced sale of other assets.
- A series of weak economic indicators in the United States, most of which came from the industrial sector.
- Worries about the escalating problems in the U.S. subprime mortgage market.

These events occurred at a time when markets were overdue for a correction.

No Signs of a Looming Bear Market

None of the catalysts for the current sell-off foretell an impending recession or new bear market. The Chinese stock markets, for example, are one of the poorest indicators of China’s financial and economic health and aren’t a helpful tool for predicting global financial markets.

The yen “carry trade,” meanwhile, isn’t as large as it has been made out to be, nor is it likely to end at current interest and exchange rates.

The developments in the subprime mortgage market warrant more attention. Though still below 2002 highs, subprime delinquencies have rapidly risen from their 2004 cyclical lows. Industry lending standards, as a result, are tightening. Also, the marketing of repossessed properties probably will increase pressure on home prices. This means the downturn in the housing cycle may be deeper and more prolonged than previously expected.

But there’s little evidence that subprime problems are seriously affecting the rest of the

mortgage industry, and the subprime issues are not symptomatic of broader consumer problems. The potential “spillover” is currently contained, and credit markets are functioning smoothly for both housing and other products.

So while we’re likely to see greater volatility in the markets for a while, it doesn’t signal a fundamental problem.

Economic Environment Remains Strong

This is true in large part because the global economic and financial situation remains strong. While the United States is releasing some mixed economic news, economic growth remains solid, if slightly below potential. Earnings growth this year is expected to be around 6%. And while this may seem like a modest figure compared to our record 14 quarters of double-digit growth, at this stage in the business cycle, 6% growth is very good.

This growth also is supported by positive monetary policy and conditions. Policy rates, spreads, money supply, credit availability and even central bank reserves all remain strong globally. And these factors define liquidity, which is strong.

In addition, employment is growing, wages are rising and production is recovering from a modest inventory cycle. Corporate balance sheets and operating margins also remain remarkably strong. Financial conditions, overall, remain stimulative, and monetary policy is supportive.

The response of the dollar to the market turbulence also has had a stimulative effect. Interestingly, when the market turbulence began, the dollar didn’t go up as it normally does in a flight to securities. Rather, it’s been weakening, which has a stimulative effect.

The global economy also remains strong, despite the increased volatility, and is in its fifth year of expansion above-trend.

In short, a minor correction isn’t surprising, given the strength and duration of the bull market. But there is nothing that has fundamentally changed in the healthy underlying economic or financial environment. ■