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## The Return of Fear

After a dreadful week for the market last week, the S&P 500 declined another 6.7% on Monday, one of the worst one-day declines in the post-war era. This brought the losses since the beginning of last week to 13.4%, and 17.9% since the end of April. We often preach that it is difficult to explain with certainty why the market goes up or down on a given day or in a given week. But the logical culprits for this correction are Washington and Europe. Our legislators may have come to an agreement on a deal to raise the debt ceiling and to address the budget deficit, but the market didn't seem to approve. One thing about markets that Washington might not seem to understand: they are difficult to fool.

With their pact last week, the politicians may have achieved the necessary short-term cuts, but they have yet to address the core problems that are driving the growth in expenditures: Social Security, Medicare, and Medicaid. On a certain level it is understandable that they have avoided structurally reforming these programs - they believe it is political suicide. This is the crux of the problem.

Seemingly more hopeless is the situation in Europe, where some members of the Eurozone are running massive deficits or carrying ballooning debt balances but lack some of the options, and perhaps the inclination, to take the steps that a sovereign nation normally would to correct the problem, because they are part of a larger economic community with a single currency. At least the US has its own currency, central bank, and control over its own destiny, even if it lacks the political will (so far) to do what is necessary. Germany is faced with a recurring choice of spending billions to bail out its neighbors, an action that is increasingly unpopular at home, or refusing and watching the Eurozone crumble, with each nation exiting the union. The inevitable conclusion to all this, whether it is three weeks or three years from now, might be the latter. Margaret Thatcher, who was against the idea of Great Britain adopting the Euro - which it did not - is looking smarter by the day.

Back to the stock market. People were reminded again over the past several days that fear trumps greed. The market had climbed rather steadily since last summer but gave nearly all of it back in a few days. Extreme moves, especially on the downside, perpetuate themselves in a cascading fashion, for a number of reasons - momentum traders, heavily leveraged hedge funds, investors who can't take any more pain and bail out thereby exacerbating the slide, margin calls that force selling, etc. It's obvious that the intrinsic value of public companies did not decline by 13% since August started. But markets aren't always rational.

On Monday, the CBOE Volatility Index, or VIX, which measures the implied volatility of options, closed at 48. The VIX is known as the "fear index," and it has rarely reached this level, eclipsing 44 on only 8 previous occasions in its 25-year history, according to Hays Advisory. On all but one of these (September 2008), it marked the approximate bottom of the correction. Of course there is no guarantee that Monday was the bottom, but this amount of fear is generally a good sign. It's also reassuring that purchases of stock by company insiders are at levels not seen since March 2009, another market bottom.

Laffer Associates looked at recent examples of downgrades of the AAA debt of developed nations: Japan (1998), Spain (1998 and 2009), and Canada (1994). In each case, the equity market of the country in question declined on the downgrade, only to gain back more than it had lost in the following months and years. Paradoxically, in each case, the country's currency appreciated on the news of the downgrade. We wouldn't read too much into these precedents, as there are differences with today's situation. But they are worth noting.

The irony of the recent market action is that one of the issues, the now-suspect credit-worthiness of the US (which the market recognized well before the downgrade by Standard & Poor over the weekend), has driven a flight to safety into the very securities that are now riskier! During this stock market correction, investors have fled to the safety of Treasury bonds, forcing yields down. All else equal, one would have expected yields to *rise*, given the increased riskiness of the debt. But this factor is being overwhelmed by the fact that during a correction, and when there are concerns about the economy, investors crave safety, and there is not yet a realistic alternative in the safety department to Treasury debt.

All of this has created an extreme relationship between bond yields and the earnings yields on stocks, making stocks extremely attractive relative to bonds. But in times like these, people don't care.

A potential danger is that our government, watching Treasury yields (America's borrowing costs) fall, concludes that the fiscal situation really isn't that serious, prompting it to address the deficit/debt with less urgency. This would be tempting fate. What our leaders need to recognize is that when things change, they can change quickly. Something that is not a problem can quickly become one. Treasury rates may be low, and they may stay low for a while, but when the market decides it does not want to hold our paper, it can become a self-reinforcing upward spiral (for interest rates).

On Tuesday the market recovered most of the ground it had lost on Monday, rising 4.7%. This is a major move for one day, and the cyclically-oriented sectors performed even better. Wednesday started with a selloff. Time will tell whether we have seen the bottom of this correction, but we believe that those who did not panic will be rewarded.

Best regards,



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