Sentinel Investments℠

Market Insights

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Volatility is back. While U.S. markets were closed for the Martin Luther King, Jr. holiday on January 21, European and Asian markets entered meltdown mode, falling 5% to 7% in most cases. Selling continued in Asia the following day, with markets down another 5% to 7% — and even lower midday.

The U.S. market seemed ready to follow suit, with futures trading indicating the potential for a 523-point drop at the opening. And indeed, stock prices did fall sharply, with the Dow[1] down by 460 points at its worst moment on January 22.

In all markets, the sell-off was blamed on the increasing likelihood of recession in the United States, as well as the contagion in financial companies around the world from the write-down of sub-prime debt. It also appears that a major French bank closed unauthorized trading positions on Monday the 21st, thus creating more uncertainty.

These events show that global economies remain fundamentally "coupled" and that a slowing U.S. economy will affect all regions. The Fed knows that most economic indicators lag the real economy. So, in a preemptive move, it acted quickly to contain the damage, slashing the Federal Funds rate by three-quarters of a point at 8:20 am on January 22. The cut came between meetings — with the next regular Open Market Committee Meeting scheduled for January 29 — demonstrating a real sense of urgency. The Fed also left the door open for future cuts, in its statement recognizing "weakening of the economic outlook and increasing downside risks to growth." The Fed's action stopped the downslide, with the Dow[1] ending January 22 down only 155 points.

Markets have stabilized in the days since; however, both the U.S. and global markets will likely face further tests in the weeks to come. Earnings for a broad sector of companies over the next several weeks will set the tone for the market — and any unexpected weakness will likely set off further volatility. The market will also be looking for any signs of further deterioration in the U.S. economy, and may react to bad news sharply.

However, we do not think the world is heading into recession, and with the Fed willing to cut rates so dramatically and the U.S. Congress poised to enact a stimulus package in the form of rebate checks, any actual U.S. recession could be short-lived. Meanwhile, market turmoil creates opportunities.

By cutting rates, the Fed has further weakened the dollar, which should make it easier for U.S. companies to sell to the export markets. We see selective opportunities in companies with exposure to the fast-growing developing markets, since they should be better able to compete with a weaker dollar. Export-related businesses — like railways, aerospace and capital equipment — should perform well. Commodities have historically been attractive in weaker dollar environments, so we are exploring possibilities there as well.

We also see opportunities in Europe and Asia. Many European companies have adopted or extended restructuring programs to help manage costs and deliver bottom-line results. We saw this with U.S. companies in the mid-1990s, despite slower growth mid-decade and a strengthening currency. In Asia, stocks linked to growth in China and India have been on a tear, but are seeing significant corrections in the current environment. Thus, we think a good buying opportunity is emerging over the next five to ten years, benefiting from growth in two very important economies for the world.

And more broadly, the market downturn means that many of the stocks we favor are currently trading at lower multiples — consequently offering higher earnings yields and, in many cases, higher dividend yields.

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The recent market volatility is unsettling, but it has changed nothing about how we analyze and manage securities. We continue to manage portfolios as we always have, with the same disciplined processes that have added value over time. We believe that investors who diversify across a wide range of asset classes and global markets, and who take a long-term view and pay attention to fees and expenses, have the best chance of achieving their goals in any market environment. As always, we thank you for your business, and hope you will get in touch with me or any of my Sentinel colleagues if you have any questions or concerns.

[1] The Dow Jones Industrial Average is an unmanaged index which represents share prices of selected blue chip industrial corporations, as well as public utility and transportation companies. An investment cannot be made directly in an index.