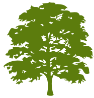

Johnston Investment Counsel
LIFE THE WAY YOU PLANNED IT.

Welcome To 2016

Well, it's all over the news. The stock market has had a very rough start to 2016. Through January 20th, the stock market has lost -9% of its value. In fact, the stock market has not had a worse start to a calendar year. It seems appropriate to put things into context.

What's Going On?

While no one knows for certain, the common reasons for the decline have been the continual decline in oil prices, slowing growth in China, and the strong U.S. dollar. It's also worth noting that the stock market's valuation has been on the high side for a while. This leaves it more vulnerable to a correction on any hint of bad news.

Oil prices are down to levels not seen since 2003, and could go lower, which is not terrific news for oil companies and oil services companies. There is legitimate concern about repayment of high-yield bond debt among some higher-risk energy companies. Politically, the energy price collapse is also a challenge for certain countries that heavily rely on oil revenue (Brazil, Russia for example). But cheaper energy **is** good news for manufacturers and consumers -- which is sometimes forgotten in the gloomy forecasts.

Chinese stocks and the Chinese economy are showing more signs of weakness. The confidence in the ability of the Chinese authorities to "manage" their economy is eroding. China has a significant amount of debt and appears to have created too much productive capacity. They do have significant monetary reserves, which will probably give them some time. Nevertheless, a significant currency adjustment is a real possibility as well as additional fallout.

Is this 2008-2009 Again?

While the correction may or may not get worse, we do not believe another "2008" is around the corner for the following reasons:

- U.S. and European banks are much healthier today than they were in 2007.
- There hasn't been a big credit boom in the U.S. and Europe like there was during the housing bubble. Some of the energy companies may have borrowed too much, but they are nowhere near the economic size of the housing bubble that occurred.
- Consumer balance sheets are much healthier today than they were in 2007.
- Even if China is a financial house of cards their financial system isn't interlinked to the U.S. and Europe in the same way that the U.S. and Europe are interlinked.

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We believe the majority of evidence suggests that a recession is not imminent – or even likely to soon occur. But, this does not mean the stock market cannot go down further – it certainly can.

Putting Corrections Into Historical Context

Let's put this -9% intra-year decline into a historical framework. The chart on page 3 shows the intra-year decline in stock prices since 1980, as well as the full calendar-year return.

The median intra-year decline in stock prices since 1980 has been -10.5%. An intra-year decline of -10% or more has occurred in 20 out of the 36 calendar-year periods (or 56%). So a -10% intra-year decline is not particularly uncommon. A -15% decline has occurred less frequently (13 of the 36 periods or 36%), but still more than once every three years.

Since 1980, 28 years (or 78%) had positive stock market returns. Interestingly, of the 20 years that had an intra-year stock decline of -10% or more, 13 had positive returns for the full calendar year. So, historically speaking, it is not uncommon (although by no means a certainty) for the market to be able to "digest" even a -10% intra-year decline and still have a full-year positive return.

Lastly, it is important for any stock investor to realize that stock prices can decline at any time, with no warning whatsoever. This is why investors in common stocks need a longer time horizon – probably a minimum of five years, and preferably longer.

The chart on page 4 shows the frequency of a below zero returns for a 50% stock / 50% bond or 100% stock portfolio. Historically, the S&P 500 has produced a negative one-year calendar return 27% of the time. That probability declines to 14% over a five-year timeframe, 5% over 10 years, and 0% over a 20-year holding period.

The investor with a 50% bond portfolio has had a 20% frequency of a negative one-year return, but less than a 6% chance of a negative return for holding periods of 3 years or longer.

Please note that these type of statistics are only designed to provide historical context. The future may be significantly different than the past.

Conclusion

Whether this will be a -10%, -20%, or worse correction, only time will tell. But it is worth noting that, in the past, every one of these drawdowns eventually ended with an even greater upturn and markets testing new record highs.

S&P 500: Intra-Year Stock Market Decline vs. Calendar Year Returns
Price Change Only (Excludes Dividends)

Year	Intra-Year Decline	Calendar Year Return
1980	-17%	26%
1981	-18%	-10%
1982	-17%	15%
1983	-7%	17%
1984	-13%	1%
1985	-8%	26%
1986	-9%	15%
1987	-34%	2%
1988	-8%	12%
1989	-8%	27%
1990	-20%	-7%
1991	-6%	26%
1992	-6%	4%
1993	-5%	7%
1994	-9%	-2%
1995	-9%	34%
1996	-8%	20%
1997	-11%	31%
1998	-19%	27%
1999	-12%	20%
2000	-17%	-10%
2001	-30%	-13%
2002	-34%	-23%
2003	-14%	26%
2004	-8%	9%
2005	-7%	3%
2006	-8%	14%
2007	-10%	4%
2008	-49%	-38%
2009	-28%	23%
2010	-16%	13%
2011	-19%	0%
2012	-10%	13%
2013	-6%	30%
2014	-7%	11%
2015	-12%	-1%

- There has been an intra-year decline in the S&P 500 every year since 1980. The average / median decline has been -14.2% and -10.5% respectively. The maximum intra-year decline has been -49% while the minimum has been -3%.
- An intra-year decline of at least -10% has happened 56% of the calendar years since 1980. A -15% decline or -20% has occurred 36% and 17% of the calendar years, respectively.
- Since 1980, there have been 8 calendar years (22%) where the S&P 500 produced a negative calendar-year return.
- Even though intra-year declines of -10% are pretty common, the market has generally rebounded to produce a positive calendar-year return (at least 78% of the time since 1980).

Historical Frequency of Negative Returns
50% Stock and 100% Stock Portfolios
90 Years of Data From 1926 to 2015

	50% Stock	100% Stock
1 Year	20.0%	26.7%
3 Years	5.7%	17.1%
5 Years	4.7%	14.0%
10 Years	0.0%	4.9%
20 Years	0.0%	0.0%