

## OAK ASSOCIATES, *ltd.*



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### Wild Ride

The market went on a wild ride Thursday. The Dow at one point was down 9.2%, a decline greater than any one-day drop since 1987. It closed down 3.2%. The S&P 500 also closed down 3.2%, after being down 8.6%. The midday dive may have been exacerbated by high-frequency trading firms (which normally provide liquidity) deciding to stop trading, as well as by sell programs that kicked in when losses hit a certain level. The latter is reminiscent of portfolio insurance, which was blamed for the 1987 crash. But those are technical factors. The fundamental explanation for the selloff and the correction that began in April is the sovereign debt problem in Europe. Greece, a member of the European Union, is at risk of defaulting on its debt given its fiscal imbalance. The thinking is that such an event could have a cascading effect on other European countries and possibly the rest of the world.

As sharp as the correction has been in the US, it has been even worse in Europe. The authorities there of course want to fix the problem, but the problem is that there is no easy solution. When the euro was introduced in 1999, it created monetary interdependence between the various nations in the EU. This limited the ability of members to control their money supply and exchange rates, since they no longer had their own currency. This restricts the ability of a state to inflate its way out of fiscal problems by devaluing its currency; the inability to do this may sound like a good thing, but in this case it is not. It is safe to say that if Greece, which produces only 2% of EU GDP, were still in control of its own currency, it would not be having anywhere near the effect it is having on the global markets. The problem is that Greece's troubles (and possibly others such as Portugal's and Spain's) are now the rest of Europe's. There is already talk of ending the euro and going back to sovereign currencies, but that isn't realistic in the short term, especially with all the jitters in the market.

What is the best course of action? We've seen suggestions that the European Central Bank needs to implement some form of quantitative easing (as opposed to monetary easing), similar to what the Fed did during the height of the financial crisis. This would entail the purchase of assets across various European markets, which would provide much needed liquidity. We think this makes sense and would not be surprised to see something like this announced in the coming days.

One of the truly bizarre aspects of the correction on Thursday is the price at which many stocks changed hands. Several blue chip stocks traded briefly at unimagined levels. Proctor and Gamble, which had closed above \$62 per share the day before, traded below \$40 on Thursday and finished at \$60.75. Philip Morris began the day above \$48, hit \$2, and closed at \$47. Accenture started just below \$42, traded as low as one cent (yes, that is correct), and closed above \$41. While the market did swing wildly, these swings are not representative of the trading in either the market or the stocks themselves. There was nothing fundamentally happening with these companies that would explain such moves. The unheard-of prices appear to be a result of automated computer selling combined with a lack of buyers, and there is talk that such prices may be "corrected" over the next few days. In other words, the trades will be revised to reflect more reasonable prices.

One gauge of the uneasiness that pervaded the market Thursday is the volatility index, or VIX, which measures the amount of volatility implied in options prices. It is sometimes referred to as the “fear index.” The VIX started the day below 25, eclipsed 40, and closed at 32.8, a gain of 32%. For perspective, it topped out at 80 in the midst of the financial crisis in late 2008, but otherwise has not been above 40 since 2002.

One more note on the euro. If indeed this is the beginning of the end for the euro, perhaps we should have seen it coming. Two of the great minds of the 20<sup>th</sup> century, Milton Friedman and Margaret Thatcher, stood steadfastly against the idea when it was in its infancy. Friedman didn’t think the currency would survive its first crisis, and Lady Thatcher stated, “If you have a single currency you give up your independence. You give up your sovereignty. That we must never do.”

What should investors do now? As is usually the case, we believe the best course of action with activity heightened and emotion running rampant is to not get caught up in the frenzy, but look for opportunities when they present themselves. We recently did a little de-risking in our client accounts and mutual funds – not because we knew this was coming (we didn’t), but because we believed it was prudent to do so after the strong run in the market and economically sensitive stocks. All of a sudden the interest in seeking safety has increased. But the time to make such moves is not when everyone is interested in making them.

At times like this, it is important to remember that stock prices represent the discounted value of a firm’s future cash flows. Earnings season is winding down, and first quarter profits have been very strong, even though revenues are just starting to recover to previous levels. Despite the myriad of worrisome big-picture issues (budget deficit and national debt, increased regulation and taxation, a deleveraging consumer, unemployment, Europe, etc.), corporate America is healthy and companies are trading at reasonable valuations. We don’t know when this correction will end, but the profitability of the underlying businesses bodes well for the long-term.

Best regards,



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