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# STAY CALM WHILE OTHERS PANIC

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Chief Investment Officer

As Clark Capital's Chief Investment Officer, Sean oversees all of the Firm's investment activities and heads the Firm's portfolio team. Sean joined the Firm in 1993 and is responsible for asset allocation and investment selection for Navigator Investment Solutions as well as directing ongoing market research and contributing to the development of proprietary products. Sean is a member of the Clark Capital Board of Directors, the Investment Committee and the Management Committee. He graduated from the University of Delaware, earning a B.S. and an M.A. in Economics. Sean is a Chartered Financial Analyst and a member of the CFA Institute (formerly AIMR) and the Financial Analysts of Philadelphia, Inc. Sean is considered an industry expert and is often asked to appear on CNBC and Bloomberg television to share his views on the market. In addition, Sean has been featured in a number of articles in nationally distributed business journals and newspapers.

Stay calm while others panic — easier said than done. Warren Buffett is famous for saying, "Be fearful when others are greedy and greedy when others are fearful." Are we at that point after only a few days of decline? We might be. We will spend a little time here to assess where the market is and what to expect now that there is blood in the streets.

Earlier in the year, we discussed the fact that we had seen volatility across asset classes, beginning with commodity volatility, spreading to currencies, and then to credit. The next logical spot for volatility to land was in equities and that has happened with stocks plunging globally as investors flee risky asset classes. What triggered the plunge was the Chinese government's decision to devalue the yuan and worries over a global economic slowdown. However, there was definitely deterioration under the surface with breadth diverging, credit spreads widening, defensive sectors assuming leadership, and the market narrowing over the past seven months while the S&P 500 traded in a sideways channel. Once the channel was broken to the downside, the selling pressure intensified very quickly turning into an environment of outright panic.

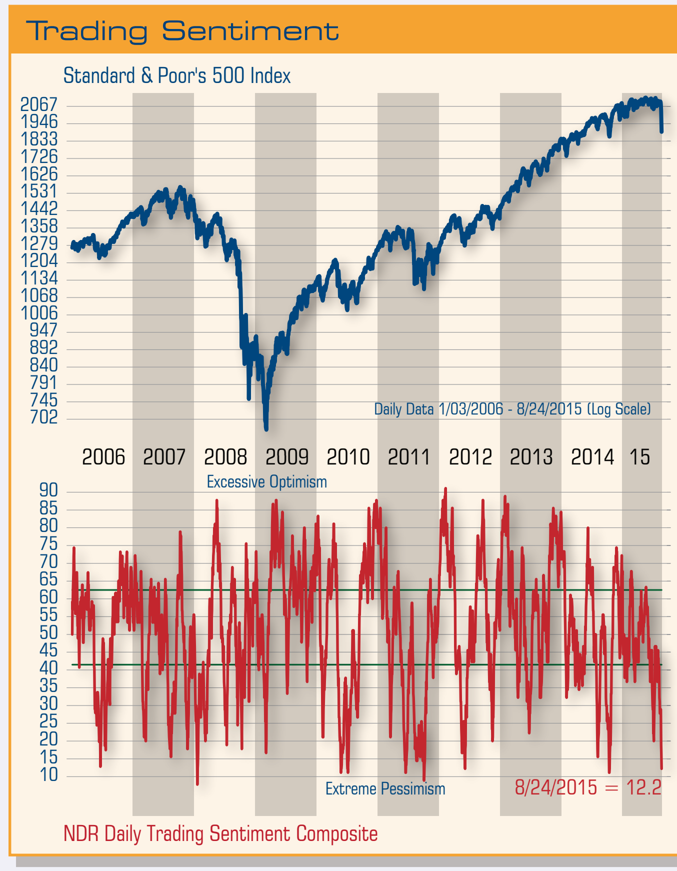
We did take steps in recent weeks to get a bit more defensive in our allocations. For example, credit spreads (high yield – 10 year Treasury) have widened out from a low of 366 bps on June 3rd to 552 bps. Widening credit spreads were an early indication of a potential weakening of the markets, and our models for Fixed Income Total Return shifted from favoring high yields to favoring treasuries on July 27th. Since then, high yields have weakened and treasuries have benefited from a flight to safety. We have successfully avoided the volatility in credit and profited so far in Treasuries, but the flight to safety trade has not been as strong given the prospects of a Fed rate hike. Treasuries have surely rallied recently, but not as strongly as in the past when stock market turmoil erupted. In addition, we did dial back the betas of equity rotation strategies including Style, Sector, and International Opportunities by allocating to large caps, defensive sectors and away from emerging markets to developed markets.

All the major indexes are now in correction territory having declined by more than 10% from their respective highs. The market was well overdue for this correction. It has been three years since the market suffered a 10% correction in 2012, the third longest period without a 10% correction since 1928. On average, the S&P 500 has had three 5% or greater corrections per year – one 10% correction every year, one 15% correction every two years, and one 20% or greater correction every three years. The S&P 500 is now down 11.1% from its May 21st high through Monday's close.

Volatility exploded higher last week with the CBOE Volatility Index (VIX) experiencing its largest one week percentage change in history, and on Monday it surged and hit an intraday high of 53.29. This is the highest level of VIX since the Financial Crisis in early 2009. We don't think this is the beginning of another 2008-style collapse but rather a much needed correction within a longer uptrend. The U.S. economy is expanding with leading indicators signaling no recession on the horizon, the housing sector of the economy is expanding and lower oil prices are a boon for consumers. The decline is likely to prove a good buying opportunity even if it does extend further into outright bear market territory, which we don't expect. However, it is important to note that bear markets and corrections not accompanied by an economic recession tend to be shallower in magnitude of losses and shorter in time.

The market is now extremely oversold and investor sentiment has reached pessimistic extremes. The market can become more oversold and sentiment can deteriorate more, but the evidence suggests that most of the price damage may have already occurred. At the lows on Monday morning, the S&P 500 traded as low as 1867, very close to the October 2014 closing low of 1862, which should provide a level of support. If history is any guide, the waterfall decline we saw over the past several days should serve as a cleaning for the market. Stop losses have been hit, margin calls have been made, and many weak holders of stocks have been chased out of the market. Technically, sentiment readings are now supportive, including the Ned Davis Research Daily Trading Sentiment Composite, put/call ratios have surged, and stocks hitting 20 day lows hit a high of 54% on Friday and hit 90% intraday on Monday, which is the highest level since 2011. That has the markings of a capitulation event.

**The Ned Davis Research Daily Trading Sentiment Composite** has reached a true pessimistic extreme that is rarely seen. The history of this sentiment indicator suggests strong gains at this level of depressed sentiment. In addition, according to Sundial Capital, many measures of technical oversold conditions have been met that have led to gains in the past. See the table for performance of the S&P 500 at 1 week, 2 weeks, 1 month, 3 months, 6 months, and 1 year after significant technical oversold conditions have been met including similar three day losses: VIX > 50, back to back 90% down volume days, and more than 40% of the NYSE issues hitting new 52-week lows.




Source: Ned Davis Research

## S&P 500 Performance – Mean Returns

| 1 Week | 2 Weeks | 1 Month | 3 Months | 6 Months | 1 Year |
|---|---|---|---|---|---|
| After 8% Three Day Loss within Six Months of 3-Year High (since 1928) | | | | | |
| 5.2% | 5.1% | 4.2% | 10.8% | 15.6% | 18.6% |
| After VIX>50 (since 1986) | | | | | |
| 4.5% | 4.1% | 6.8% | 9.2% | 9.6% | 12.9% |
| After Back to Back 90% Down Volume at 6-Month Low (since 1962) | | | | | |
| 6.5% | 7.8% | 6.8% | 5.7% | 12.9% | 26.1% |
| After More than 40% of NYSE Issues Hit 52-Week Low (since 1965) | | | | | |
| 2.7% | 1.7% | 3.3% | 3.1% | 7.0% | 15.0% |

Source: Sundial Capital Research

So, with all of these technical oversold and washed out sentiment statistics in place, what's next? Given the declines and global market turmoil it seems likely that the Federal Reserve will postpone a rate hike until December or later. In fact, many Wall Street firms are now pushing out the expected timing of rate hikes. Barclays said on Monday that their new forecast for the first rate hike is now March. In addition, the International Monetary Fund's Christine Lagarde warned that it was too soon for a rate hike because of the global instability triggered by China. For the markets, a period of rebound rally and then retest or partial retest of the lows is likely and would not only be normal but very healthy in our opinion. This process could take several weeks or months. An important indicator of the health of the market will be how it behaves on a rebound attempt and as it approaches strong resistance near 2040 on the S&P 500. We will be watching the health of any rebound rally for signs of accumulation. Given the extent of the damage, the market is in need of repair and that normally takes time.



The S&P 500 measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

The Dow Jones Industrial Average is a stock market index that shows how 30 large publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

The NASDAQ Index is a market-weighted index of all common stocks listed on the NASDAQ exchange.

The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performers of developed markets outside the U.S. and Canada.

The MSCI World Index is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance.

The MSCI World Index ex. U.S. is a free float-adjusted market capitalization index that is designed to measure global developed market equity performance excluding the U.S.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The MSCI All Country Europe is a free float-adjusted market capitalization index that is designed to measure the performance of European equity markets.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

The VIX Index is a forward looking index of market risk which shows expectation of volatility over the coming 30 days.

Barclays U.S. Government/Credit Bond Index measures the performance of U.S. dollar denominated U.S. Treasuries and government-related and investment grade U.S. corporate securities that have a remaining maturity of greater than one year.

The Barclays U.S. Aggregate Bond Index covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities. To qualify for inclusion, a bond or security must have at least one year to final maturity, and be rated investment grade Baa3 or better, dollar denominated, non-convertible, fixed rate and publicly issued.

The Barclays U.S. Corporate High-Yield Index covers the dollar-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

Index returns include the reinvestment of income and dividends. The returns for these unmanaged indexes do not include any transaction costs, management fees or other costs. It is not possible to make an investment directly in any index.

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