L. Roy Papp & Associates, LLP
Investment Counsel

2201 East Camelback Road
Suite 227B
Phoenix, Arizona 85016
(602) 956-0980
FAX: (602) 956-7053

VIEWS FROM CAMELBACK MOUNTAIN

Market Correction

During the last half of September and the first half of October, we have seen a sharp market sell off. We believe this is a normal market correction, which we have thought was a possibility all year. Wall Street calls a market correction a decline of 10% or more. Bear markets are defined as 20% declines or more. The Russian stock market and the market for oil are currently in bear market territory. The Dow Jones Industrial Average is down approximately 7%, which is rapidly approaching a correction level. Three important questions at this time are:

1. *What is causing this?*
2. *Is this a normal correction that will cease when the market is down 10% - 15% from a beginning level and will likely stabilize or recover over the next 3-9 months, or is it the start of a more serious and long-lasting decline?*
3. *Lastly, should I do anything about it and if so, what should I do?*

To provide some perspective, the U.S. stock market normally has a correction of 10% or a little more approximately every 12-18 months. We have not had one in the past three years, which has led us to be concerned that a correction may be overdue. Markets will typically react to a geopolitical event, a natural disaster, changes in regulation or taxes and other factors. This typically causes a sell off until markets decline to a level where buyers re-enter the market. We believe that the historically low interest rates and unprecedented accommodative Federal Reserve policy has caused hedge funds and other investors to rush to purchase stocks as soon as modest declines of 3% - 6% occurred. The influx of buyers stopped the market declines from getting to a 10% or larger correction. This time the market is concerned about a variety of issues all occurring simultaneously. That is why we believe that this decline may well continue and become a 10%+ correction.

Addressing the first question, there are a variety of factors causing the market decline. The arrival of Ebola and even the limited spreading of this disease in the U.S. is a terrifying prospect. Even though we have little confidence in the CDC and the Department of Health and Human Services, we are confident that the outbreak will be contained in the U.S. and that appropriate safety protocols will be put in place to protect the public. We are also confident that the international community will rally together and provide massive resources to West Africa to deal with this crisis. Economically, airlines and other travel related companies are under severe pressure and this will probably create a slow drag on consumer confidence and spending. It is not likely to impact corporate earnings, dividends or cash flow for most companies.

A more significant economic impact is coming from a very weak economy in Europe, which we have been concerned about for the last few years. We now believe that Germany is at the beginning of a recession and most of Europe will experience a recession over the next year or perhaps a little longer. Until the last thirty days, financial markets believed that if greater weakness developed in Europe, the European Central Bank would simply begin a quantitative easing program, much like the U.S. Federal Reserve has utilized over the last several years. Unfortunately, we think that ill-advised monetary policy from the Federal Reserve and central bankers around the world have left Europe in a position where monetary policy, including a quantitative easing program, is unlikely to be very effective at staving off a recession in Europe. We believe that Europe is currently in a recession and that it will simply need to run its course.

A recession in Europe will lower global demand for oil and energy, will lower the demand for European imports from the United States and China, and will lower activity levels at American companies doing business in Europe. All of these factors are a drag on some American businesses and a small drag on the U.S. economy. They represent a slightly larger drag on the growth rate of the Chinese economy as Europe is China's number one export destination. Lower oil and energy prices, in turn, hold down inflation and tend to drive down other commodity prices as well. This will probably mean that the Federal Reserve and other central banks around the world will leave interest rates low for a while longer.

The markets are also concerned about hostilities in Iraq and Syria, protests in Hong Kong and a wide variety of other factors. Specific industries like airlines and other travel companies, oil companies and a few other industries have been hit hard.

The second question, "Is this just a normal correction that will cease when the market is down 10% - 15% from a beginning level and will likely stabilize or recover over the next 3-9 months, or is it the start of a more serious or long-lasting decline?" The kinds of conditions that would make the market ripe for a more severe and long lasting decline would be a serious recession in the U.S. We know of no credible economist who is currently predicting a serious recession in the near term. If the Federal government allowed interest rates to dramatically rise, or was considering a large tax increase or other disruptive activity, we would be concerned. We do not anticipate any of these developments. If our banking system was vulnerable to a meltdown or if certain important sectors of our economy, such as housing, were experiencing a bubble of unrealistic valuations, we would be concerned. If stock prices appeared to be very high based on a variety of fundamental indicators such as price earnings ratios or other common valuation metrics, we would be concerned. In our opinion, none of these conditions are present. We are convinced that this is a normal correction from which the markets are likely to recover over the next 3 - 9 months.

The last question is "what do I do about this?" If I owned European stocks, I would consider making some sales at this time. If I owned companies that are heavily exposed to the European or Chinese economy, I might make some reductions. If I owned stocks that are crazily overpriced, I might consider sales right now. Other than these conditions, we expect that half or more of the decline has already occurred and selling most stocks at this point is ill advised. Our clients own high quality stocks that are well seasoned and where the businesses they represent are capable of enduring disruptions. These companies have strong balance sheets and great cash flow, which should help them weather the storm. We have received a few calls from clients recently inquiring if it is time to make some stock purchases. With all of the uncertainty and the enormous amount of volatility we suggest our clients wait until most of the storm clouds pass, even if we end up paying a little more for fresh stock purchases. Our best advice is to simply hold on and not be too concerned about the headlines of the day. We are watching conditions carefully and we will let you know if there are any material changes.

Best regards,

Harry Papp
Managing Partner
October 15, 2014