US Markets and Economy: The surging US stock market was tripped for a loss in January. In a long-term bull market, investors should expect periodic and healthy “corrections” in which stock values decline between 5% and 15% before resuming their rise. January’s correction, in what is normally one of the strongest months on the calendar, can be put down to several factors: foremost is the continuing “taper” of the Federal Reserve’s Quantitative Easing (QE) program. Some of the liquidity injected by the Fed spills into financial markets both in the US and abroad, and the shrinkage of this stimulus has clearly weakened stock prices in the short run. January’s stock market decline occurred against a backdrop of increasing economic strength in the US: real GDP in the US is beginning to accelerate, employment growth is steady (in spite of December’s weather-induced weakness), and unemployment continues to drop. Housing, which has been a key driver of the economy in the recovery from the credit collapse, showed some signs of weakness at the end of the year, but again it was hard to tell how much was a result of poor weather in much of the country. Overall, housing prices continue to rise, construction is strengthening, and, in another positive development, the number of “underwater” homes in America has continued to fall steadily.

Inflation remains very low, and is actually below the Fed’s target of 2%. This means the Fed has significant leeway to keep short-term interest rates at zero for many months, even as QE is gradually withdrawn. Janet Yellen, an experienced and talented central banker, has now taken over the reins of the Fed from Ben Bernanke. She is strongly committed to returning the economy to “full” employment, as long as inflation remains subdued.

World Markets and Economy: An old Wall Street expression: “When Uncle Sam sneezes, the rest of the world catches a cold.” Sure enough a “sneeze” on Wall Street has looked much more calamitous in the rest of the world, where stock markets have swooned in tandem with the US. Especially in poorly managed economies like Turkey and Argentina, the sudden outflow of “hot
money” back to the US, in anticipation of higher interest rates, has sparked currency and financial crises. While difficulties in these countries can cause little direct damage to the economic behemoths of America and Europe, many market players remember the “Asian Contagion” of 1997-98, when a currency crisis starting in Thailand spread to much of Asia. Shock waves from this crisis eventually arrived on America’s shores, causing a sharp but temporary dip in the US stock market. Weakness in emerging markets’ stock prices is a useful reminder that the higher returns possible in these countries come with higher risks. The flow of hot money back to the US has also pushed down US long-term interest rates, since the US is still the world’s safe haven in times of trouble. This backflow makes the Fed’s job of tapering QE easier, since lower interest rates help stimulate economic growth even as the central bank continues to taper.

Weak economic conditions in Europe, where unemployment in the Eurozone remains at 12%, is acting as an additional drag on stock markets from Germany to Greece. Most forecasters call for growth to resume across the Eurozone soon, but all signs point to subpar economic growth, which is the normal outcome after a financial crisis. China, the second largest economy in the world, may also be sneezing, as Chinese leaders attempt to slow economic growth to a more sustainable level, and “rebalance” the economy to be less reliant on exports and investment. Smaller countries, such as Australia, accustomed to supplying the Chinese growth engine with raw materials, are thus more likely to catch a cold.

OUTLOOK:
The US stock market is in the grip of a correction, a normally healthy development in a bull market. It is almost impossible to predict when such a correction will run its course, although 10% corrections are normal fare in many bull markets, including this one. If the current correction is a garden-variety 10%, the markets are more than halfway through it already. But long-term investors should shun attempts to time the market’s short-term gyrations, given the risk of missing out on stocks’ long-term upward trend. Emerging markets are likely to be even more volatile than developed markets, but these stock markets are also impossible to “time” on a short-term basis. Bonds, which are likely to drift down over the course of the year as interest rates rise, benefit from economic and financial uncertainty, and thus provide risk-reducing diversification during corrective movements in stocks.