



## After the Deluge: Aftermaths of High-Volume Market Corrections Since 1965

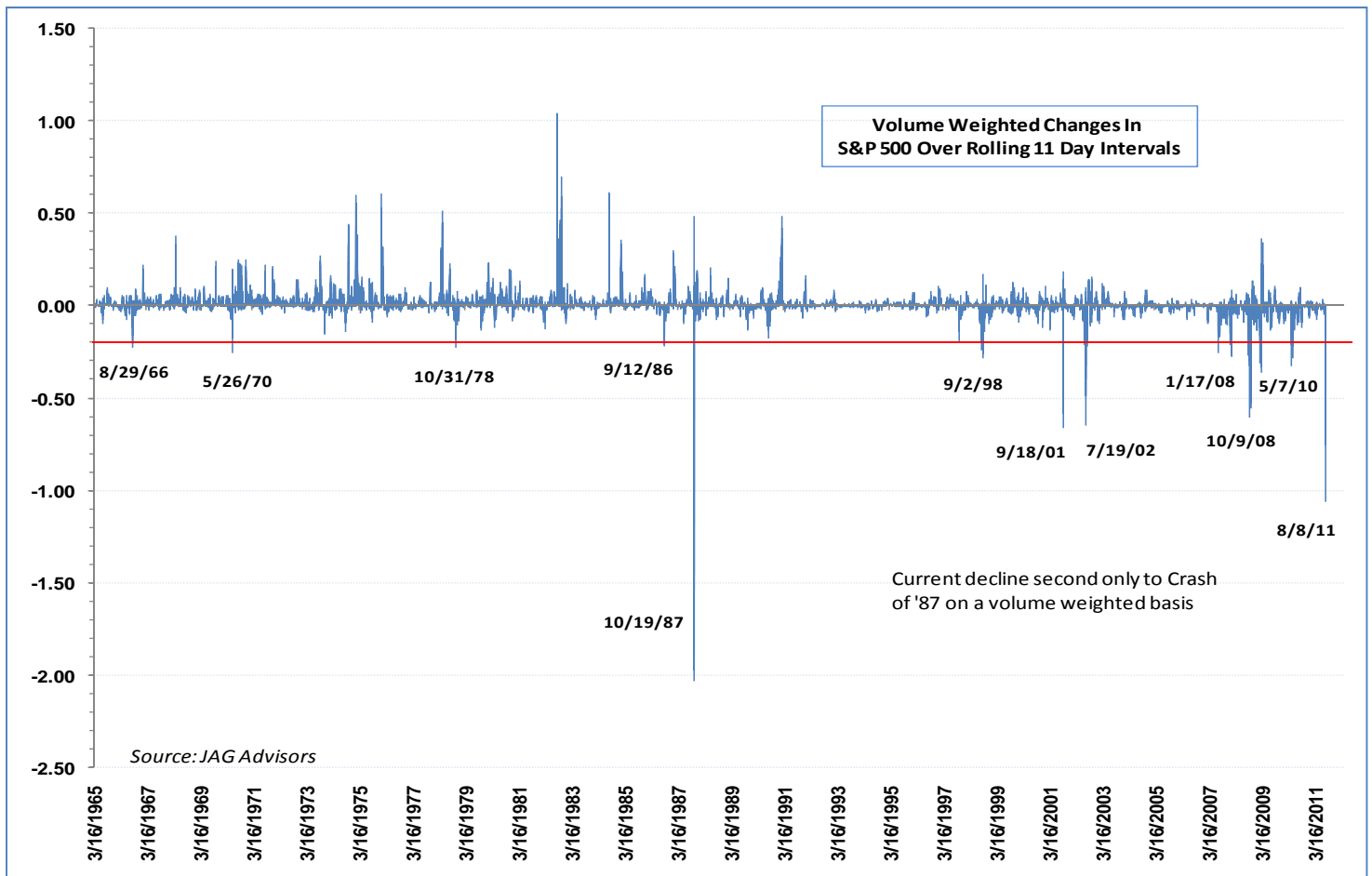
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### Background

To paraphrase Tolstoy, "All happy markets are alike; all unhappy markets are unhappy in their own way." The U.S. stock market became *very* unhappy over the past several weeks, declining by almost 17% between 7/22/11 and 8/8/11. Given the unusual intensity of this sell-off, we thought it would be worthwhile to compare it to past market corrections to provide some un-emotional context to the equity market outlook over the coming months.

### Methodology

The recent correction has been characterized by the confluence of three conditions: (1) we have experienced a significant decline in stock prices, (2) coupled with unusually high trading volume, and (3) occurring over a short time period. We applied a time period of 11 trading days in our analysis, because this time interval encompassed the sharpest portion of the most recent correction in stock prices. We then looked back at market history to find other examples in which each of these three conditions co-existed in the stock market. In order to accomplish this, we created a combined weighted indicator to examine rolling 11-day S&P 500 price changes coupled with a measurement of trading volume. Instances in which the combined indicator was below **-0.2** were characterized as an extreme reading. After eliminating any dates with repeated extreme readings within three-week windows, we created the following chart:



### **S&P 500 Performance After Extreme Volume-Weighted Oversold Readings**

Our analysis uncovered 15 previous examples in which the S&P 500 had experienced short-duration sell-offs on abnormally high trading volume. We then examined S&P 500 returns for a variety of time periods *after* these sell-offs. The chart below details the results of our findings:

				<b>S&amp;P 500 Performance</b>				
				<b># of Trading Days After Extreme Oversold Reading*</b>				
<b>#</b>	<b>Date</b>	<b>SP5_C</b>	<b>VolWtdROC11</b>	<b>5</b>	<b>20</b>	<b>60</b>	<b>122</b>	<b>253</b>
1	8/29/1966	74.53	-0.21	3.3%	4.8%	7.6%	17.3%	24.9%
2	5/26/1970	69.29	-0.26	12.3%	7.9%	11.1%	20.1%	43.6%
3	10/31/1978	93.15	-0.23	0.8%	0.6%	9.4%	9.5%	9.3%
4	9/12/1986	230.67	-0.22	0.7%	2.1%	8.9%	25.0%	40.1%
5	10/19/1987	224.84	-1.01	1.3%	9.7%	9.4%	20.8%	24.3%
6	9/2/1998	990.48	-0.20	-1.0%	-0.4%	20.4%	24.8%	37.0%
7	9/18/2001	1,032.74	-0.28	-2.0%	6.3%	10.1%	11.6%	-18.3%
8	7/19/2002	847.75	-0.21	0.6%	9.6%	-0.7%	9.3%	16.6%
9	8/20/2002	937.43	-0.22	-0.3%	-7.3%	-5.9%	-12.8%	7.0%
10	8/3/2007	1,433.06	-0.26	1.4%	2.9%	7.5%	-4.9%	-10.3%
11	1/17/2008	1,333.25	-0.21	-0.2%	1.3%	0.1%	-7.9%	-39.6%
12	9/17/2008	1,156.39	-0.27	2.5%	-21.5%	-24.5%	-34.6%	-7.6%
13	10/9/2008	909.92	-0.30	4.0%	-0.6%	2.7%	-8.2%	18.3%
14	2/27/2009	735.09	-0.20	-7.0%	11.0%	23.8%	39.6%	52.1%
15	5/6/2010	1,128.15	-0.21	2.6%	-5.6%	-0.2%	4.9%	18.8%
16	8/8/2011	1,199.38	-0.75	?	?	?	?	?
	<b>Average</b>			<b>1.3%</b>	<b>1.4%</b>	<b>5.3%</b>	<b>7.6%</b>	<b>14.4%</b>
	<b>Median</b>			<b>0.8%</b>	<b>2.1%</b>	<b>7.6%</b>	<b>9.5%</b>	<b>18.3%</b>
	<b>Max</b>			<b>12.3%</b>	<b>11.0%</b>	<b>23.8%</b>	<b>39.6%</b>	<b>52.1%</b>
	<b>Min</b>			<b>-7.0%</b>	<b>-21.5%</b>	<b>-24.5%</b>	<b>-34.6%</b>	<b>-39.6%</b>
	<b>% &gt; 0</b>			<b>66.7%</b>	<b>66.7%</b>	<b>73.3%</b>	<b>66.7%</b>	<b>73.3%</b>
<p><i>*Extreme oversold reading is based on an 11 day rate-of-change for the S&amp;P 500 weighted by the total deviation of NYSE volume from its 50d ema also over an 11 day interval. An extreme reading for this table is defined as one below -.2. Multiple readings in a 15 (trading) day period have been excluded.</i></p>								

### **Implications for Equity Investors**

Technical analysis seeks to find patterns in historical data that share certain characteristics with current conditions. If appropriate comparisons are made, this sort of analysis of *past* outcomes can help us to gain potential insights into *future* potentialities.

For equity investors, technical analysis can provide some welcome perspective during a sell-off that has been painful and, at times, frightening. The pain is illustrated by a volume weighted decline reading of **-0.75** as of 8/8 – a level of selling pressure second in intensity only to the Crash of '87 (data back to Mar-1965).

Now that we have established how painful the correction has been (the correct answer: “*quite*”), we turn our efforts to gauging the potential implications for the near- and intermediate-term equity market outlook. In this respect, the historical data is quite clear: equities have shown a clear tendency to trade *higher* in the weeks and months following intense corrections.

Looking out one year (253 trading days), the S&P 500 was higher **73%** of the time while racking up an average gain of **14.4%** in the process. This is encouraging data, but of course there are some exceptions. There have, indeed, been situations in which stocks have traded *lower* a year after a climactic selling event. Typically, these sorts of disappointing returns occurred in the context of larger bear markets which were accompanied by broad economic slowdowns. Examples include the periods following the 9/18/2001, 8/3/2007, 1/17/2008 and 10/9/2008 sell-offs.

One needs only to glance at the print and Internet media to know that the global economy faces a plethora of challenges in the coming months. That said, the intense media coverage of these roadblocks increases the likelihood that the markets have substantively priced in any further bad news that is likely to develop.

Therefore, we believe the weight of the historical evidence favors a constructive view on equities. Barring a significant and sustained deterioration in the global economy or some other exogenous shock, we believe the odds favor positive absolute returns for equities over the coming year.

**Norm Conley**  
CEO & CIO

**Mike Buck, CFA**  
Quantitative Analyst

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