Strategist's Corner
6 February 2018

A correction, not a likely turning point

Author

James Swanson, CFA
Chief Investment Strategist

A number of factors appear to have contributed to the selloff in equity markets that commenced last week and picked up steam in a volatility-driven decline on Monday, 5 February. While the decline was eye-catching, Monday's 4.1% drop was only the 25th largest in the history of the S&P 500 Index.

Contributing factors

When considering why the market staged such an abrupt pullback, we must begin with valuations. Over the past 12 to 18 months, a synchronized global upturn in economic growth, low inflation and low interest rates have helped support equity valuations, pushing them well beyond historical norms. Trailing earnings for the S&P 500 ended 2017 at nearly 22x, significantly above the 10-year average multiple of 15.7x. Stocks have been expensive for some time, and while earnings have been robust of late, price advances have more than kept pace.

Aside from lofty valuations, among the most pressing concerns for investors in the past few days have been growing signs that inflation pressures are beginning to build after a prolonged period of very modest increases in consumer prices. Friday's US employment report showed a jump in average hourly earnings of 2.9% on an annualized basis, the biggest rise since the early phase of the post–financial crisis recovery in 2009. In addition, the prices paid components of the Institute for Supply Management's purchasing managers' indices have surged as well. The manufacturing reading came in at 72.7 in January while the nonmanufacturing measure rose to 61.9, well above the demarcation line between expansion and contraction. So with strong increases in both of these indices coupled with high readings for new orders and order backlogs in each series, investors are increasingly fearful that economic bottlenecks are developing, which could lead to higher prices and a potential overreaction by the US Federal Reserve.

As a result, bond yields have risen in recent months, with the rise accelerating since the beginning of the year. From around a 2.40% yield in early January, US 10-year Treasury notes reached 2.89% this morning. However, accelerating equity losses set off a flight to quality that saw yields fall back to 2.70%. With yields having been so low for so long, bonds are suddenly providing some competition with equities at these higher yields levels.

A further major contributor to the rapid selloff is a spike in market volatility. The Chicago Board Options Exchange Volatility Index (VIX) averaged 11.2% over the past 12 months, an abnormally low level. As equities have ground ever higher over the past year, very large short-volatility positions have been building in the markets — largely in volatility-targeting strategies employed by institutional investors and leveraged exchange-traded products geared toward individuals. Once equities reversed, the VIX spiked as high as 39% on 5 February and 50% on 6 February, which led those who were short volatility to hedge their positions by selling shares in the underlying S&P 500 Index. This likely exacerbated the market selloff.

One final factor that may be increasing market jitters is the arrival of the new Fed chair and several new governors and regional reserve bank presidents. Most of the newly appointed officials are viewed as somewhat more hawkish than those they replaced. Few think the Fed is likely to make wholesale policy changes anytime soon, but at the margin, the new FOMC is seen as potentially more likely to raise rates more quickly than last year's voters.

Solid fundamentals

The pullback in recent days is approaching a correction, or a 10% decline from the most recent market top. So far, we're well-short of a bear market, which is defined as a 20% decline from the 52-week high. It is important to note, however, that not all bear markets lead to recessions. In the post–World War II era, there have been nine bear markets that did not subsequently trigger recessions. Eight other bear markets were followed by a recession shortly thereafter. So bear markets have a decidedly mixed record in forecasting economic downturns. Given the broad, and in many cases accelerating, strength in the global economy, it seems unlikely that the recent downturn in prices is pointing toward an imminent recession.

Conditions don't appear to be in place for a prolonged market downturn. Corporate balance sheets remain strong, while fourth-quarter earnings have surpassed expectations. Additionally, the credit markets aren't signaling that a major shift in risk appetite has taken place. High-yield bond spreads have widened, but only marginally, from historically tight levels. Recent yield increases in non-investment-grade bonds have been driven more by rising Treasury rates than by growing credit concerns. That's a source of comfort for equity investors.

In my view, the market decline is an opportunity for investors to reorder their portfolios and perhaps increase equity exposures. Historically, spikes in volatility have represented buying opportunities. According to data from Credit Suisse, when the VIX moves above 20%, S&P 500 returns over the subsequent 3 months average 6.4%. When the VIX moves above 25%, subsequent 3-month returns average 6.9%.

Concluding thoughts

Market selloffs like the one we have just lived through are dramatic, but can provide opportunities. These opportunities are apparent as long as the market is not signaling the risk of an impending recession. The markers of coming recession have increased, but not alarmingly so. Credit spreads and forward orders are not pointing toward recession, but signs of late-cycle dynamics have increased.

Investors should be patient, and prepared to add modestly to risk, especially in equities. Overall, it will be important to maintain a cautious balance with a pronounced tilt toward companies with proven and sustainable patterns of strong free cash flow generation and free cash flow margin.

The cycle is in its ninth year and the last recession has been forgotten by many, including much of Wall Street. But the next one does not appear to be looming. So there is an opportunity this winter to modestly extend stock holdings. But remember that late cycle is a time to focus on capital preservation, not wringing every last penny out of the market.

MFSE-SWANSON-NL-2/18
34792.25