Another Sharp Pullback, but Not the Start of a Bear Market

Buying US Equities on Weakness

The sharp pullback in stocks in October is another correction in an ongoing bull market, in our view, rather than the early stages of a more prolonged downturn. We believe US equity markets are much more likely to rebound and end the year higher from current levels (as of October 29th) than continue selling off.

The proximate spark for the selloff appears to be US Federal Reserve (Fed) Chair Jerome Powell’s October 3rd comments on Fed policy. “We may go past neutral,” he acknowledged, in reference to the possibility that the Fed’s planned rate hikes were at risk of overshooting the hypothetical neutral rate, also called R*, which perfectly balances unemployment and inflation. “But we are a long way from neutral, probably.” (See our recent piece “R*, Rock Star or Dark Star?”) This raised fears that the Fed might be headed toward overtightening and making a policy mistake. However, even before that, the list of downside risks was long: emerging market turmoil, continued US-China trade tension, Italian fiscal troubles, the Brexit stalemate, and concerns about peak economic and earnings growth. The US stock market had largely been shrugging off the building stress, but no more.

Should this drawdown reach 10%, it would be the second correction for US stocks this year. Overall, equity market volatility has picked up this year from unusually tranquil levels in 2017. (See chart below) We believe the pickup in market volatility and higher frequency of drawdowns is a normal side effect of central bank tightening and the maturing cycle, but does not herald the end of the bull market.

The Return of Volatility

---

As of 10/29/2018.
Source: QMA, FactSet.

For Professional Investors Only.
All investments involve risk, including the possible loss of capital.
Our more constructive outlook for equities stems from our investment framework. We look at the macroeconomic environment and the business cycle dynamics as well as valuation and fundamentals, and we also take into account the market’s current sentiment. At present, our framework is supportive of the decision to rotate some exposure from cash and core bonds to US equities based on what we believe to be temporary weakness.

**Macro environment is still benign and corporate fundamentals sound**

QMA’s Business Cycle Indicator shows that the US economy is still in an expansionary phase. Further, the indicators on our US recession dashboard suggest the risk of recession is still low, with the yield curve still positively sloped, high yield spreads still reasonably tight, initial unemployment claims still near historic lows, and the Conference Board Leading Economic Indicators Index still in an uptrend. GDP for Q3 came in at a solid 3.5%, underpinned by an impressive jump in consumer spending, pushing the quarterly annualized rate to 4%. Meanwhile, scattered disappointments aside, corporate earnings reported for Q3 have so far been positive, with nearly 82% of companies delivering positive earnings surprises, well above the historical average. In addition, now that the buyback blackout period is nearly over we expect US corporations to resume share repurchases at a brisk level, providing additional support for stocks.

**Valuation has improved**

The S&P 500 is now trading at 15 times its forward earnings, compared to 17 just a month ago and 18.5 at the end of January. This is a significant reduction, in the 49th percentile relative to 20 years of history. As a result, we believe valuation is much less of a headwind looking forward.

**Sentiment is shifting**

Our analysis of a host of sentiment and technical metrics, such as volatility, short-term price momentum and investor flows suggests that the market is in a state of panic, spanning multiple asset classes and sentiment metrics. However, our empirical analysis suggests that extreme stress typically recedes and a relief rally ensues. Therefore, we believe the recent rout should be followed by a sharp rebound especially given the solid fundamental backdrop described above.

While we believe global stocks are also discounting an overly bearish outlook for global earnings and the global economy, we are concentrating our buying on US stocks as the very solid near-term US fundamentals give us greater conviction that this market is due for a near-term bounce. US stocks could certainly fall further with the uncertainty of the mid-term elections looming, but we are fairly confident that we will see a typical post-election rally into year end.
ABOUT QMA
Serving investors since 1975, QMA targets superior risk-adjusted returns by combining research-driven quantitative investment processes built on economic and behavioral foundations with judgment from experienced market practitioners. Ultimately, each portfolio is constructed to meet the individual financial needs of the client. An independent boutique backed by the capabilities of one of the world’s largest asset managers, QMA is the quantitative equity and global multi-asset solutions business of PGIM, the global investment management businesses of Prudential Financial, Inc.

Today, we manage approximately $128 billion* in assets for a wide range of global clients.

*As of 9/30/2018.

NOTES TO DISCLOSURE

This is intended for Professional Investors only. All investments involve risk, including the possible loss of capital. Past performance is not a guarantee or a reliable indicator of future results.

These materials represent the views, opinions and recommendations of the author(s) regarding economic conditions, asset classes, and strategies. Distribution of this information to any person other than the person to whom it was originally delivered is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of Quantitative Management Associates LLC (“QMA”) is prohibited. Certain information contained herein has been obtained from sources that QMA believes to be reliable as of the date presented; however, QMA cannot guarantee the accuracy of such information, assure its completeness, or warrant that such information will not be changed. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. QMA and its affiliates may make investment decisions that are inconsistent with the views expressed herein, including for proprietary accounts of QMA or its affiliates. These materials are for informational or educational purposes. In providing these materials, QMA is not acting as your fiduciary.

In Europe, certain regulated activities are carried out by representatives of PGIM Limited, which is authorized and regulated by the Financial Conduct Authority (Registration Number 193418), and duly passported in various jurisdictions in the European Economic Area. Quantitative Management Associates LLC, which is an affiliate to PGIM Limited, is an SEC-registered investment adviser, and a limited liability company. PGIM Limited’s Registered Office, Grand Buildings, 1-3 Strand, Trafalgar Square, London WC2N 5HR. In Japan, investment management services are made available by PGIM Japan, Co., Ltd., (“PGIM Japan”), a registered Financial Instruments Business Operator with the Financial Services Agency of Japan. In Hong Kong, information is presented by representatives of PGIM (Hong Kong) Limited, a regulated entity with the Securities and Futures Commission in Hong Kong to professional investors as defined in Part 1 of Schedule 1 of the Securities and Futures Ordinance. In Singapore, information is issued by PGIM (Singapore) Pte. Ltd. (“PGIM Singapore”), a Singapore investment manager that is licensed as a capital markets service license holder by the Monetary Authority of Singapore and an exempt financial adviser. These materials are issued by PGIM Singapore for the general information of “institutional investors” pursuant to Section 304 of the Securities and Futures Act, Chapter 289 of Singapore (the “SFA”) and “accredited investors” and other relevant persons in accordance with the conditions specified in Sections 305 of the SFA. In South Korea, information is issued by QMA, which is licensed to provide discretionary investment management services directly to South Korean qualified institutional investors. The opinions expressed herein do not take into account individual client circumstances, objectives, or needs and are therefore not intended to serve as investment recommendations. No determination has been made regarding the suitability of particular strategies to particular clients or prospects. The financial indices referenced herein is provided for informational purposes only. You cannot invest directly in an index. The statistical data regarding such indices has been obtained from sources believed to be reliable but has not been independently verified.

Certain information contained herein may constitute “forward-looking statements,” (including observations about markets and industry and regulatory trends as of the original date of this document). Due to various risks and uncertainties, actual events or results may differ materially from those reflected or contemplated in such forward-looking statements. As a result, you should not rely on such forward-looking statements in making any decisions. No representation or warranty is made as to future performance or such forward-looking statements.

SPECIAL RISKS
Foreign investments may be volatile and involve additional expenses and special risks, including currency fluctuations, foreign taxes and political and economic uncertainties. Emerging and developing market investments may be especially volatile. Investments in securities of growth companies may be especially volatile. Due to the recent global economic crisis that caused financial difficulties for many European Union countries, Eurozone investments may be subject to volatility and liquidity issues. Value investing involves the risk that undervalued securities may not appreciate as anticipated. Small and mid-sized company stock is typically more volatile than that of larger, more established businesses, as these stocks tend to be more sensitive to changes in earnings expectations and tend to have lower trading volumes than large-cap securities, creating potential for more erratic price movements. It may take a substantial period of time to realize a gain on an investment in a small or mid-sized company, if any gain is realized at all. Diversification does not guarantee profit or protect against loss.

Emerging markets are countries that are beginning to emerge with increased consumer potential driven by rapid industrial expansion and economic growth. Investing in emerging markets is very risky due to the additional political, economic and currency risks associated with these underdeveloped geographic areas. Fixed-income investments are subject to interest rate risk, and their value will decline as interest rates rise. Unlike other investment vehicles, U.S. government securities and U.S. Treasury bills are backed by the full faith and credit of the U.S. government, are less volatile than equity investments, and provide a guaranteed return of principal at maturity. Treasury Inflation-Protected Securities (TIPS) are inflation-index bonds that may experience greater losses than other fixed income securities with similar durations and are more likely to cause fluctuations in a Portfolio’s income distribution. Investing in real estate poses risks related to an individual property, credit risk and interest rate fluctuations. High yield bonds, commonly known as junk bonds, are subject to a high level of credit and market risks. Investing involves risks. Some investments are riskier than others. The investment return and principal value will fluctuate and when sold may be worth more or less than the original cost.

Copyright 2018 QMA. All rights reserved. QMA-201801028-334