MARKET PULSE

October 31, 2018

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

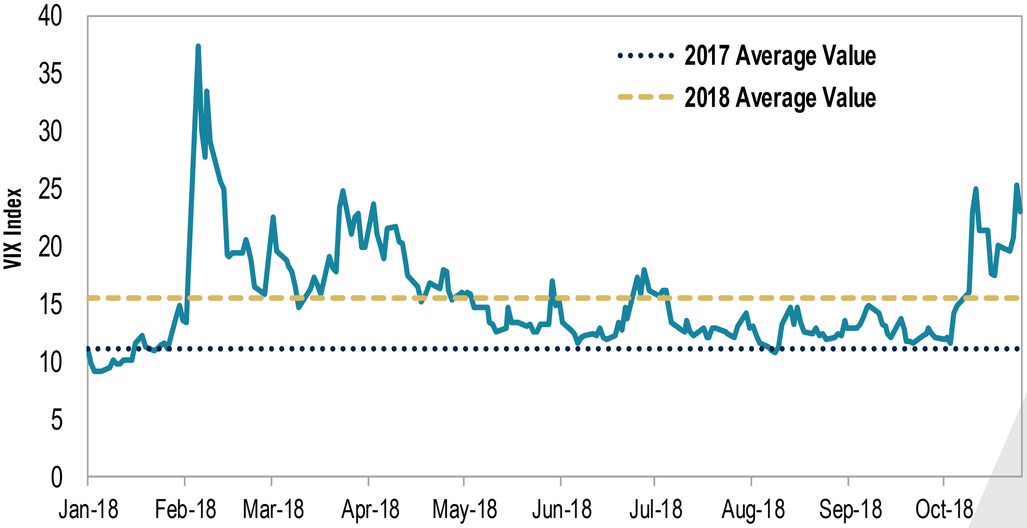
Buying US Equities on Weakness

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.

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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.

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*As of 9/30/2018.

NOTES TO DISCLOSURE

Sources: QMA, The Wall Street Journal, Board of Governors of the Federal Reserve System, Federal Reserve Bank of Kansas City, Federal Reserve Bank of New York, Federal Reserve Bank of San Francisco, Federal Reserve Bank of Richmond.

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