CORRECTION NOT REVERSAL – WHAT THIS WEEK'S MOVES ON WALL STREET ARE TELLING US

This week a large equity sell-off underlined the volatility of the current market.

The accompanying rally in long-dated Treasuries risks being interpreted as a signal of a significant US economic downturn.

We believe that a US recession is still unlikely in the next year at least, but that price action overnight shows that the market may be losing some conviction in the long-term outlook.

Growth and Momentum stocks are bearing the brunt of the sell-off and valuations are reverting to more normal levels. Technical indicators are not indicating a broad-based reversal. Nor were volumes particularly high, which would indicate more serious concerns.

The moves appear more consistent with a correction during a longer-term expansion, than a significant reversal in trend.

Traders appear to be trimming long stock and short long-dated Treasury positions as a large amount of data is squeezed into Thursday and Friday due to the market closure on Wednesday for the funeral of George H.W. Bush. This has not been accompanied by warning signs from other markets.

We recommend holding a bias to Quality stocks and to the US in international equity allocations.

Earlier this year, the market had four major concerns:

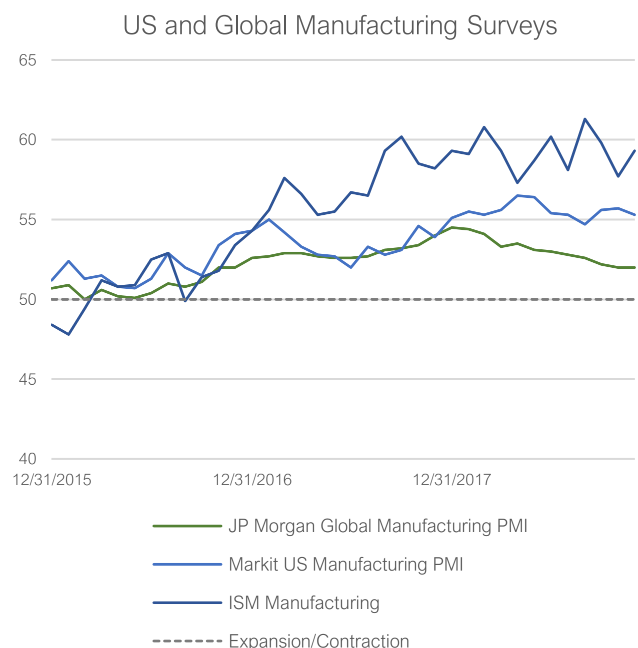
- The Fed Reserve tightening cycle
- Escalating trade tensions
- Slowing economic growth
- Falling energy prices

Last week, Fed Chair Jerome Powell appeared to suggest that the Fed might slow the pace of interest rate rises, at least after the December rate rise which is almost fully priced-in.

The G20 meeting last weekend also gave hope that the US and China would work together more closely on resolving the trade dispute. Although there remains a lot of scepticism as to whether they will make real progress in the 90-day timeframe they have so far allowed.

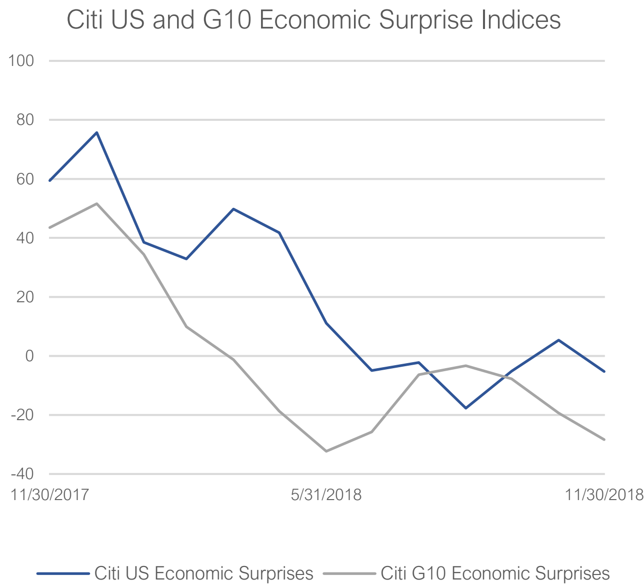
The Russians and Saudis also seemed to step closer to cutting oil production to support oil prices at the upcoming OPEC meeting. The Canadians took more concrete steps by mandating a reduction in output.

While some support for oil prices will help energy stocks, supply intervention does not change the fact that there appears to be weakening demand. In fact, there is undeniable evidence that the pace of growth is slowing globally. The PMI activity surveys from developed markets published at the beginning of this week produced relatively soft figures.



Source: Bloomberg, JP Morgan, Citi, Markit, ISM, 5 December 2018

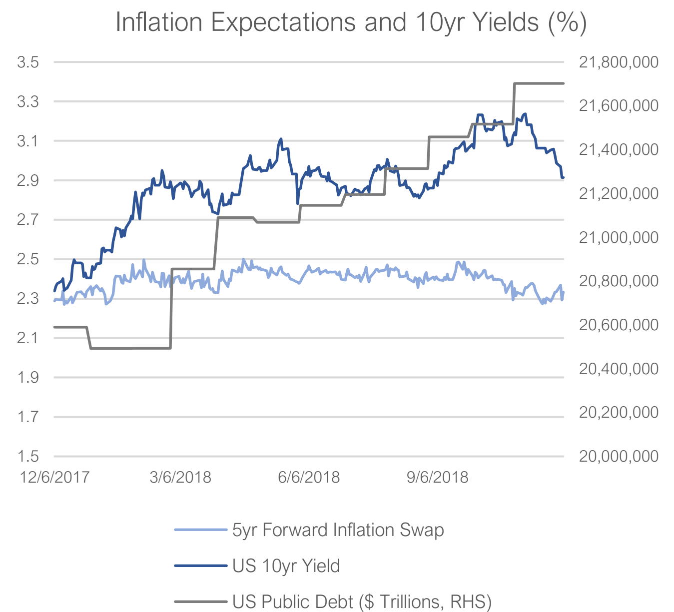
The US has, however been a notable exception. Whether you follow the Markit US PMI or the more popular ISM Manufacturing survey, both indicate a pace of economic activity which is well above the global average. So far, the Fed rate hikes are not showing up as slowing growth in the very near term. Economic announcements in the US are no longer exceeding expectations but are more or less meeting expectations on average. In contrast, the Citi G10 economic surprise index shows global economic announcements are tending to disappoint on average.



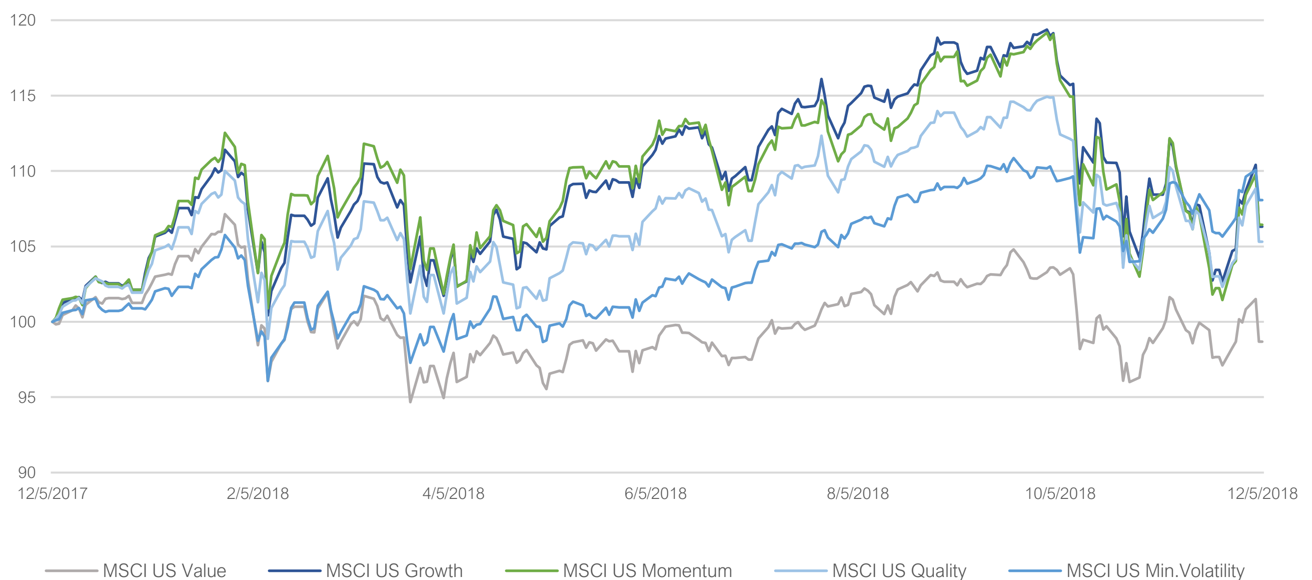
There are, however, signs that US rate rises are cooling longer-term expectations. Since the end of September 5yr5yr forward inflation expectations (the average inflation expected between 5yrs from now and 10yrs into the future) have started to recede.

10yr Treasury yields have also fallen over the same period. Up until September, the 10yr yield had been driven higher by a combination of slightly higher inflation expectations and high levels of new issuance.

Since the end of September 2017, the face value of outstanding US public debt had grown by 6.3%. The effect of new issuance was amplified by the fact that the Federal Reserve had also reduced the size of its balance sheet by 5.9% over the same period. The net effect was an increase in supply of 7.3% in high quality USD bonds in circulation. Small wonder that large US Treasury short positions had built up. But faced with a large volume of data in a short week, falling inflation expectations and a suddenly more dovish Fed, those short positions become harder to hold.



Source: Bloomberg, 5 December 2018



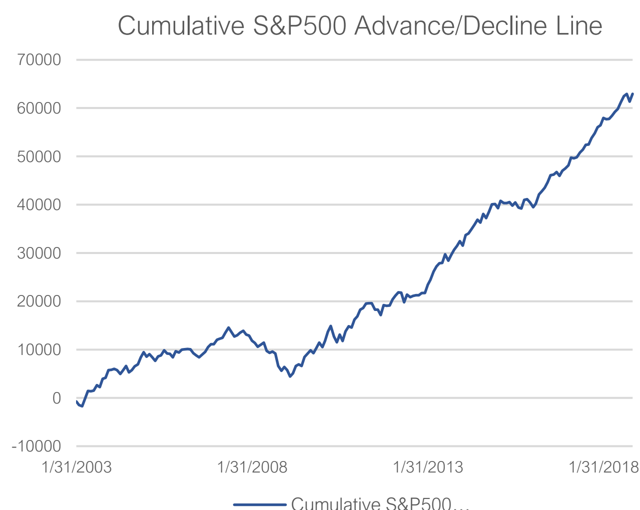
Source: Bloomberg, MSCI, 5 December 2018

Turning to the equity market sell-off, the chart above shows that Momentum and Growth stocks, represented by the respective MSCI US factor indices, have given back a significant proportion of the gains made so far this year.

Quality and Minimum Volatility stocks have shown resilience, while Value stocks have shown the strongest defensive characteristics, albeit after languishing all year.

We would resist a rotation into Value at this stage. Technical indicators are not yet suggesting that we are in the throes of a broad-based reversal linked to slowing growth and interest rate cuts.

The S&P500 cumulative advance-decline line has not flattened as in 2005-2007, nor has it shown strong signs of rolling over, as it did in 2008. Despite the recent correction, approximately on third of NYSE stocks are still trading above their 200-day moving averages[1]. Recent moves therefore appear much more indicative of a correction during a longer-term bull market.



Source: Bloomberg, 5 December 2018

More constructively, it appears that some "froth" has been blown off the market. Returning to the most followed index, the S&P500 1yr-Forward P/E ratio has fallen from close to 20x at the end of 2017, to roughly 16.5x today – much closer to the 10yr average of roughly 15.75x[2]. Of course, much of that reversion has been driven by earnings growing faster than market prices, in particular due to the US corporate tax cuts at the beginning of the year.

Source: Bloomberg, S&P Dow Jones, 5 December 2018

Our interpretation is therefore that we are in an intermediate-to-late stage phase of the market expansion. Economic growth has slowed, but not to the extent that a recession is threatening in the near future. Earnings are likely to reflect the slowing economy, so a market correction is quite understandable, and bouts of higher volatility are likely to be more frequent than in previous years given the challenging liquidity outlook.

With this outlook in mind, we believe that Quality stocks offer the best risk-reward potential. High margin, high ROE stocks with low levels of leverage should be best placed to translate economic growth into higher earnings and weather the threat of further rate rises.

Momentum and Growth stocks appear less likely to produce the strongest returns without a return to a concerted global economic expansion with accompanying liquidity creation. Companies that promise earnings growth far out in the future are likely to find market conditions more challenging than a year ago. Finally, the valuation gap in favour of Value stocks has now narrowed, suggesting less potential for outperformance without falling short-term rates.

We recommend holding a bias to Quality stocks and to the US within an international equity allocation.

[1] Bloomberg, 5 December 2018

[2] Bloomberg, S&P Dow Jones, 5 December 2018

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