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Making Sense of the Market Downturn

ECONOMIC INSIGHTS | October 2018

Key Takeaways:
- Downturns are a natural part of investing and are to be expected.
- Volatility is likely to continue in the short term.
- Strong corporate earnings should help U.S. markets recover.

After a rather tranquil spring and summer recovery from the February price correction, U.S. equities are experiencing a rather sharp pullback from their mid-September highs. As of October 11, the S&P 500 is down 6%. Other equity indices around the world have fallen into full corrective (down over 10%) mode if not into outright bear markets (down over 20%).

As is often the case in such market downturns, there's much discussion about the potential catalysts behind the reaction.

Economic and Geopolitical Factors

Here are the factors we're watching, in order of importance, to assess the markets and our investment strategies.

- **Fed Policy.** The U.S. Federal Reserve is raising interest rates even though there are no broad-based signs of inflation. Over the last three years, short-term rates have increased from near zero to over 2.0%. The Fed has been careful in both its gradual approach to raising rates and the communication of its policy. Even so, the markets often test new Fed chairmen, and Jerome Powell is no exception. His comments last week seemed to imply additional rate hikes for which the markets were totally unprepared. Other Fed governors have since suggested the Fed is closer to the end of its tightening program and probably in a position to pause the quarterly rate increases sometime next year. The clear lesson here is that effective communication remains vital to the Fed's tightening process. There is no need for any Fed member, especially the Chairman, to look too far ahead.

- **Yield Curve.** Market angst over the flattening of the yield curve was replaced by concerns over the sharp upward spike over the entire curve. The 10-year U.S. Treasury note increased 0.40% from its mid-summer lows. With the magnitude of the curve flattening and recessionary fears subsiding, attention has shifted to the potential crowding-out effect of larger fiscal deficits. One early indicator of this effect could be the less-than-stellar auction of 10-year Treasuries on October 10. With the increasing costs of hedging dollar risk, foreign bond buyers looking for higher yields may no longer be eager to purchase U.S. Treasuries. There's also some concern that the Chinese may begin to sell a portion of their huge accumulation of Treasuries in retaliation of U.S. tariffs.

- **Trade War.** Two U.S. companies in the Materials and Industrials sectors cited actual profit margin deterioration due to rising materials costs and supply chain disruption brought about by U.S. – China trade tensions. While it's difficult to determine the long-term impact of this trade war on world and U.S. economic growth, these corporate announcements likely spooked market participants in U.S. equities. Year-to-date dollar appreciation against most foreign currencies is another factor that could potentially pressure corporate profit margins over the coming quarters.

- **Emerging Markets.** The impact of heightened trade friction on the Chinese economy has reverberated throughout the emerging markets and may begin to impact growth in a number of developed-market economies.

- **Developed Markets.** European drama around the Italian fiscal budget and the ultimate shape of a U.K. exit from the European Union are a reminder of the impact a dysfunctional European political system can have on the markets.

- **Midterm Elections.** The U.S. midterm elections could exacerbate already high political tensions and volatility if Democrats regain control of both the House and Senate.

Other Factors

- **Systematic Trading.** Sharp downward moves like the one seen yesterday are also caused by systematic quantitative traders whose algorithms may have picked up sell signals. Absent any true economic or earnings news, the impact of this short-term trading should be temporary.

- **Corporate Earnings.** Third-quarter earnings season has begun in earnest with the big banks. Earnings of U.S. large-cap companies are expected to grow near 20%, a slowdown from the 25% rates of the first two quarters of 2018, but still very strong. As importantly, top-line revenue should grow in the high single digits, confirming above-average U.S. economic growth. Much attention will be paid to accompanying management commentary forecasting year end and 2019 conditions. Two things will be of particular interest in these forecasts. The first is any sign tariffs and wage costs are having a meaningful impact on profit margins. The second is evidence that tax reform is continuing to encourage corporate spending on productivity-enhancing capital equipment.

Our Perspective

In attempting to discern whether this recent market action is merely the beginning of another pullback/correction or something more sinister, we continue to believe that bear markets are caused by impending recessions. We are hard pressed to identify any recessionary signs in the current economic environment. However, the Fed should be watched closely for potential policy mistakes, which could prematurely slow growth that is just now getting back to potential. The market experience with protectionist trade policies is scant although we are encouraged by the renegotiation of NAFTA with our major trading partners.

While we believe it will be difficult to achieve further expansion of valuation multiples given higher interest rates, earnings growth will allow equity markets to recover from any short-term correction, which may ensue over the coming weeks. As always, we will continue to monitor the current volatility and update you accordingly.