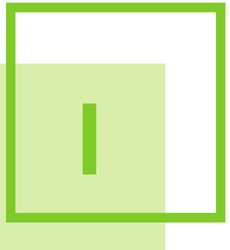
Investment Note



9 February 2018

Perspectives on the equity correction

With the Dow Jones Average Index (DJIA) suffering its second 1,000 points plunge in four days, the market has clearly entered into a correction phase[1]. The fall in the Dow from its January 2018 high has reached 10%, meeting the conventional definition for a market correction.

In this Investment Note, we put together our experts' insights from Asia to North America to help investors make sense of current market sentiment. We believe that on this occasion the price adjustment is being mainly driven by a technical correction, and not by deterioration in the economic fundamentals.

The recent correction in global stock markets was more about market internals and an overbought condition than any recent change in economic fundamentals, according to **Senior Asia Strategist, Geoff Lewis**. In other words, the correction reflected internal market issues, including forced selling from inverse and low volatility strategies that were wrong-footed by the sudden spike higher in VIX (The CBOE Volatility Index). Of course, there have also been some important changes in the macro-economic backdrop in 2018 compared to last year, when bond yields unexpectedly fell even as the synchronised global expansion gained momentum.

Rates markets today are responding to the continuation of strong economic growth and tighter labour markets that in turn are giving rise to fears of rising inflation risk and monetary accommodation being withdrawn more quickly than markets had assumed.

Even if such fears prove exaggerated, as we believe, the Goldilocks scenario for stocks of strong growth and earnings accompanied by low rates and low inflation is over, or at least unlikely to return in its full glory. That means equity markets in 2018 will most likely be muted in comparison with the stellar returns of last year.

Solid underlying fundamentals still poised for positive equity returns

Whilst corrections can often refresh, Lewis believes that a rapid return to the super-confident conditions of the January rally seems unlikely. We still expect to see decent, positive returns from most equity markets in 2018 given the solid underlying economic fundamentals. But the market's recovery in the months ahead is likely to be gradual, less certain and marked by periodic dips and bouts of volatility. For equities, 2018 could well see the return of something more like the 'Old Normal' with regard to market conditions. Investors are advised to grit their teeth but stay invested in what we expect will be a more volatile but ultimately rewarding ride.

[1] Bloomberg, Dow Jones Industrial Average dropped by 10.36% since 26 January 2018.

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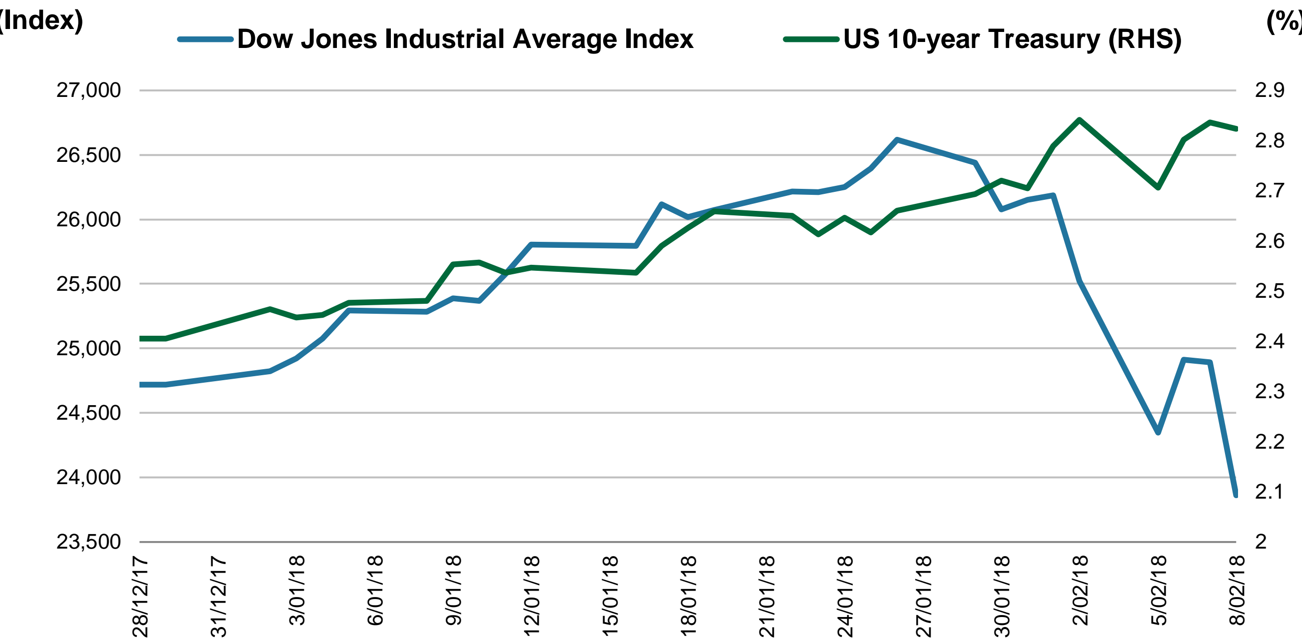
So what if US Treasury yields approaching the 3% "big figure"

Regarding 10-year US Treasury yields approaching the 3% threshold, Lewis believes a 'big figure' like 3% is usually more about short term market psychology than fundamentals. There is often volatility as one of these levels is breached, because traders are watching them closely. 3.0% is clearly one of those figures. But they have no real basis in economic theory or fundamental terms. Once passed, markets usually calm down and adapt to the new reality.

Figure 1: Market correction continues[1]



In Asia, we have been encouraged to see how Asian and Emerging Market equities have generally been relatively resilient versus their Developed Market peers during the current correction, a resilience that is all the more impressive set against a strengthening US dollar. In many previous global 'risk-off' episodes, Emerging Markets have tended to suffer an above average fall. Foreign portfolio investors quickly pulled money out of EM in a knee-jerk response, regardless of relative fundamentals and justifying their reputation as high beta, high risk assets. That this has been much less evident on this occasion is indeed encouraging. It supports our view that Asian and Emerging equities are at a long-term inflection point based on improving fundamentals that should lead to a multi-year trend of outperformance versus the Developed Markets.

EMs resilient

We observe how the high-beta and cyclical sectors/asset classes generally are holding up better in this correction than supposedly more defensive peers, for instance:

- within global equities, most of EM (versus DM)
- within DM equities, EAFE equities (versus the US)

We are inclined to take this as a positive sign with regard to underlying investor sentiment.

Overall, the ongoing sell-off represents a good opportunity to add back equity exposure to portfolios at more reasonable valuations. If, like us, the majority of real-money investors have also kept their macro outlook for 2018 broadly unchanged after the recent market turmoil, they too could well be adding rather than further reducing risk as the S&P500 approaches its longer term chart support levels.

Market movements suggest technical correction

The market movements of the past week are more indicative of a technical equities correction that has expanded than a more systematic downturn. **Bob Boyda, Head of Capital Markets and Strategy**, cites several reasons why this is likely the case. The current volatility is not meaningfully affecting credit spreads or high-yield bonds that would indicate a more broad-based sell off. In addition, other markets, such as commodities, have not been adversely affected.

In addition, while markets in the US has witnessed major movements, a large swath of emerging markets have remained resilient versus developed market peers, which is even more impressive with a rising dollar. Although some markets in Asia, notably China, Korea, and Taiwan have experienced notable volatility; the reaction has not indicated contagion across emerging markets.

Focus on the fundamentals

Although the focus has primarily been on market movements, investors should focus on fundamentals. **Megan Greene, Chief Economist** believes that we are stuck with growth moderately above potential GDP in the US and core PCE inflation stubbornly below the Fed's target (it has been at 1.2% for three months running now) remains.[2] While we do not think that red lights should be flashing that the economy is overheating, we do not think this is a weak growth story either.

The mini-correction we've seen in equities has been caused in part by higher bond yields. Some investors expect yields to blow through the 3 – 3.5% "pain mark" and rise to 4% or even 5%. We are highly skeptical of this view. Historically, the risk premium that investors demand over inflation to hold 10-Year Treasuries has tended to be the average over the previous cycle – in this case 100 basis points. If we expect inflation of 2% and a risk premium of 1%, we might get to a 10-Year yield of 3%.

In Megan's view, this stock sell-off does not represent the beginning of a major bear market. It should serve to clear out some of the froth and leverage that had been built up in the equity markets. While scary and painful, these market moves can serve to avoid even larger corrections in the future.

[2] Citigroup, February 5, 2018.

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