25 October 2018

Further thoughts on the sell-off in US equity markets

Market volatility continues in October. A sell-off that started in early October deepened on Wednesday in US equity markets: the Nasdaq lost 4.4%, while the S&P500 was down 3.1%[1]. In this market note, our global investment teams offer their views on this round of sell-off and the future market outlook. Our economists and macro strategists do not see the potential for a recession in the US in the near term.

Steve Medina, Chief Investment Officer, Global Equities

Following our previous note on 16 October[2], the market staged a brief bounce back before once again drifting lower culminating in Wednesday's (24 October) drop, with Wednesday's losses have erased the year-to-date (YTD) gains for the S&P 500 and put the market nearly into correction territory as it is down about 9% over the last month. Globally the damage has been worse: emerging markets (EM) are down nearly 18%, Europe down about 14%, and Japan down over 8%[3].

We earlier noted that the market pullback in early October seemed to be more about sentiment than fundamentals, and to a large degree that remains the case in this latest round of selling. One additional trigger may have emerged: technical selling, as the S&P500 is now trading below its 200-day moving average[3], a characteristic that has not occurred in a material way since early 2016. This is a new risk.

The market is once again oversold on a daily basis albeit coming into Wednesday's downward movement, there still did not seem to be excessive panic. Some of that may have started to change today, a condition needed for a market to begin the stabilisation process.

It is important to step back during these volatile times and assess the big picture, i.e. macroeconomic fundamentals, earnings, and valuation.

From a macroeconomic perspective, one of the keys to understanding if this market pullback is the start of a bear market revolves around the potential for a recession in the US. Currently, our economists and macro strategists do not see this possibility in the near term. The market is certainly fearful of that as seen by the rotation out of higher growth tech and healthcare names and into defensive stocks such as staples and utilities.

From an earnings perspective, the big fear being discussed is the concept of "peak earnings", meaning that we will see a slowdown in growth. Of course, this may occur in the next twelve months and the pace of earnings growth will indeed slow, but it is slowing from 20% levels of growth. While margin pressure is starting to show up in select industries, we do expect earnings to be higher one year in the future than

[1] Bloomberg, as of 24 October 2018.
[2] "The recent equities sell-off: Temporary correction or the start of something bigger?"
[3] Bloomberg, as of 24 October 2018. MSCI indices, price returns in US dollars.

they are today. There have been a select number of higher profile disappointments and earnings “guide downs” so far during the first part of the third quarter reporting season. However, there have also been some stellar reports, some of which were rewarded and some of which were not.

Ultimately, however, one always has to go back and ask: “what is in the price?” This relates to the question of valuation. In the recent past, high valuations were what made this long bull market one that was often characterized as “hated”. With this latest market pullback in price, coupled with continued earnings gains, the valuation picture continues to improve.

Overall, although we can’t tell when market sentiment will improve, we do believe that from a bottom-up fundamental level, companies are still doing well. In addition, valuations are more attractive than they have been in the recent past. This combination would seem to bode well for long-term investors. As a result, some of our portfolio managers have been putting some cash to work by adding to names with strong fundamentals that have been, in their opinion, unjustly punished.

Nathan Thooft, Head of Global Asset Allocation

A number of factors are causing anxieties for risk assets and the timeline for a resolution is uncertain. However, I believe eventually we will get more clarity on most of these issues, which should lead to some stability and recovery in equities.

We are about half way through the third quarter earnings reporting season and the results are quite good. Unfortunately, investors are laser focused on company outlooks around potential cost and margin pressures. Any hint of these factors in the earnings releases is being punished, more so than we have seen in previous quarters. Thus, despite some very decent top-line and earnings growth, the details and nuances are what investors are fixated on for the moment. Lastly, as earnings season progresses and the results remain good, I believe investors will begin to look through some of the more nuanced negatives, and importantly, we will see a return of the corporate buyers during post-earnings releases and blackout periods.

Finally, numerous important issues remain unresolved: there has been no resolution on Brexit, Italy’s budget, trade tensions, or US election results. But they will come - some sooner, some later. Post US mid-term elections also provide certainty, regardless of the outcome. There may be some jostling (negative or positive) immediately after the results, but the clarity should offer stability going into the end of 2018.

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