



# Market Note



5 December 2018

## Uncertainty and flattening yield curve spark US market correction

On 4 December 2018 (US time), US equity markets closed sharply lower. The Dow Jones Industrial Average was down by 3.1%, while the S&P 500 lost 3.2%<sup>1</sup>. Numerous issues were behind this drop: technical selling, fears of a yield curve inversion, ongoing Brexit uncertainty, and concerns about future Federal Reserve (Fed) policy. In this market note, our investment teams in the US share their views about domestic equity markets and the possibility of an inverted yield curve.

### A few reasons behind the stock market correction

Steve Medina, Chief Investment Officer of Global Equities, believes that several issues drove yesterday's (4 December, US time) drop: technical selling, fears of a yield curve inversion, ongoing Brexit uncertainty, and concerns about future Fed policy. From a technical perspective, the S&P 500 had approached key technical resistance levels in the wake of last week's strong rally. In terms of the yield curve, inversion did occur in the belly of the curve, while the important 10–2 spread (the spread between 10-year and 2-year Treasuries) also shrank<sup>2</sup> (but remains positive).

In an earlier note, we highlighted the new risk associated with trading below the S&P 500's 200-day moving average and asserted that "meaningful bottoms are a process involving additional time, a series of rallies and pullbacks, and, ultimately, price." We are now seeing this process in action. Fundamentally, equity valuations remain attractive. However, on the earnings front, we expect that analysts will lower their estimates as we move towards the end of the year, and assess the impact of actual tariffs, sentiment related to potential tariffs, and the meaningful collapse in energy prices.

From an economic perspective (according to Medina), we remain in a solid yet slowing, GDP growth environment. Our strategists still think that the US will avoid a near-term recession. This view is supported by our Bank team, which notes that the management teams they have spoken to are still confident about the economic environment. That said, our strategists also point out that given the length of the cycle, the chance of a more meaningful slowdown in 2020 is increasing. These day-to-day pullbacks seem to suggest that the market is slightly more worried that a higher-probability challenge may occur sooner than we think.

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<sup>1</sup> Bloomberg, as of 4 December 2018, US time.

<sup>2</sup> Bloomberg, on 3 December (US time), US 10-year Treasury's yield was once at 3.0479% and 2-year yield was once at 2.8109%, the spread was 23.7 basis points, the spread halved to 11 basis points on 4 December 2018.

Overall, Medina believes that we are experiencing a tug of war between a market that has suffered significant technical damage, risk-on/risk-off geopolitical and policy events, and a reasonable growth environment with undemanding valuations. Volatility will undoubtedly remain a fixture of the equity-market landscape.

### **The possibility of a yield curve inversion and its market implications**

Frances Donald, Head of Macroeconomic Strategy, has identified the key drivers behind the declining 10-year Treasury yield: (1) falling inflation expectations (mostly oil related, but also weaker inflation data) and (2) a declining term premium (on deteriorating sentiment). Critically, the growth expectations component of the 10-year Treasury yield is still rising, and the bond market is not flagging growth concerns. Meanwhile, the 2-year Treasury appears constrained by the more dovish Fed stance that has emerged over the past few weeks.

We already expect a recession in 2020, and an inverted yield curve sometime in the next six months is consistent with this call. According to past experience, this should still give investors time to make a return from US equities, as we saw in 1989, 1999, 2006, and 2007<sup>3</sup>. However, the yield curve should not invert until 2019 – even though we are dangling very close to this point as we speak. Indeed, the better predictors are still a good distance from a recession happening.

It is easy to highlight the distortions at play here. These include, on a more short-term basis, positioning issues and momentum trades. Looking at the bigger picture, global quantitative easing (QE), particularly from the European Central Bank and Bank of Japan, continues to create a global shortage of safe assets, which, in turn, depresses the 10-year Treasury yield. However, Donald is worried about being overly dismissive, as markets are clearly latching onto the narrative that the inverted curve is “bad”. In this environment, we need to tread both carefully and tactically.

Ultimately, Donald thinks this is still a “Goldilocks” macro environment, with subdued inflation and above-potential growth through 2019. We still believe that rates remain contained. Also, we continue to favour emerging markets, contained rates, and a range bound US dollar. However, more market volatility should be expected.

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<sup>3</sup> Source: Manulife Asset Management, December 2018.

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