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Quantitative & Strategy

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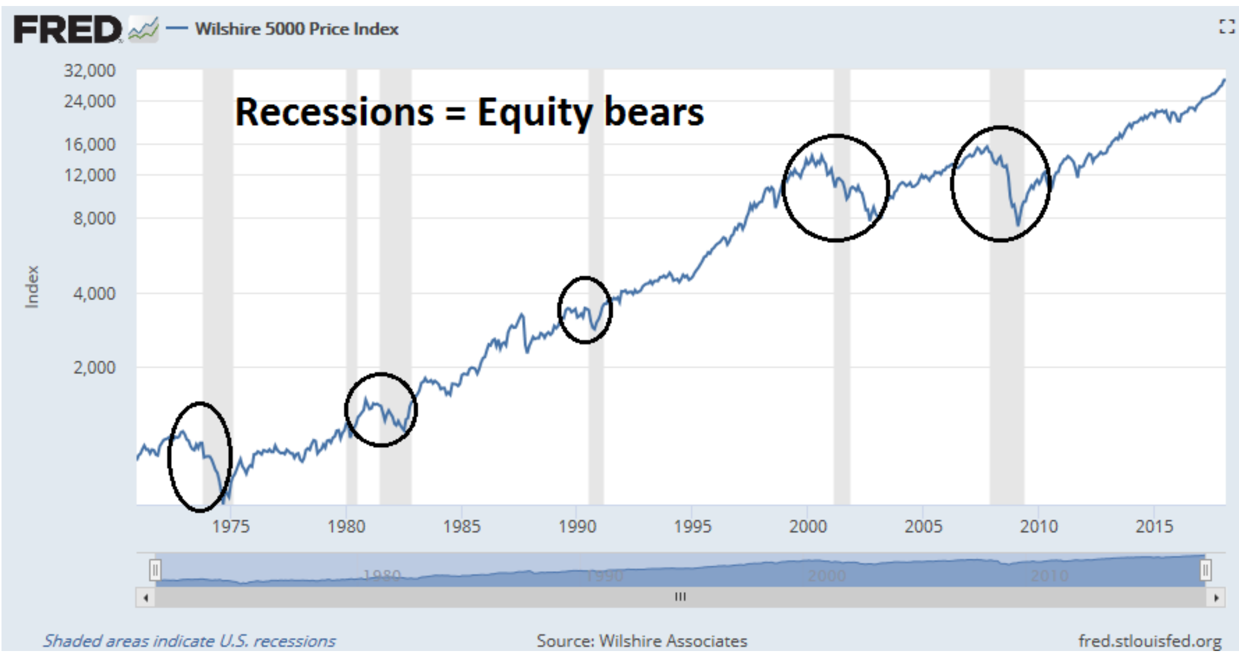
A CORRECTION, NOT A BEAR

Highlights

As U.S. stock prices cratered 3% last week, some minor panic broke out. Our analysis finds that investors should not panic, as there is no sign of a major bear market in sight.

A bear market has either preceded or coincided with past economic recessions. If there is no recession in sight, investors should not expect a major decline to begin. The corollary lesson to this history lesson is that equity investors should be prepared for regular 10–15% corrections. If you can't stand that kind of risk, you should probably reduce your equity allocation.



Our conclusion is based on the analytical framework of the long leading indicators pioneered by forecaster Geoffrey Moore. These indicators have generally peaked at least a year ahead of past recessions, and they are divided into three dimensions to measure the strength of the economy:

- Household sector
- Corporate sector
- Monetary conditions

As well, we consider the state of the market from a chartist's viewpoint.

A Correction, Not A Bear

As the stock market turned south last week, Morgan Housel of Collaborative Funds penned a timely article, *It's Hard to Predict How You'll Respond to Risk*:

> *An underpinning of psychology is that people are poor forecasters of their future selves. There is all kinds of research backing this up. Imagining a goal is easy and fun. Imagining a goal in the context of the realistic life stresses that grow with competitive pursuits is hard to do, and miserable when you can…*
>
> *The same disconnect happens when you try to forecast how you'll respond to future risks.*
>
> *How will I respond to the next investing downturn?*
>
> *[…]*
>
> *You will likely be more fearful when your investments are crashing and more greedy when they're surging than you anticipate.*
>
> *And most of us won't believe it until it happens.*

CNBC had a similar perspective. Investors have been so used to a low volatility environment where stock prices have risen steadily. When the market environment normalizes, it raises the risk of a sharp short-term sell-off should long positions in weak hands panic:

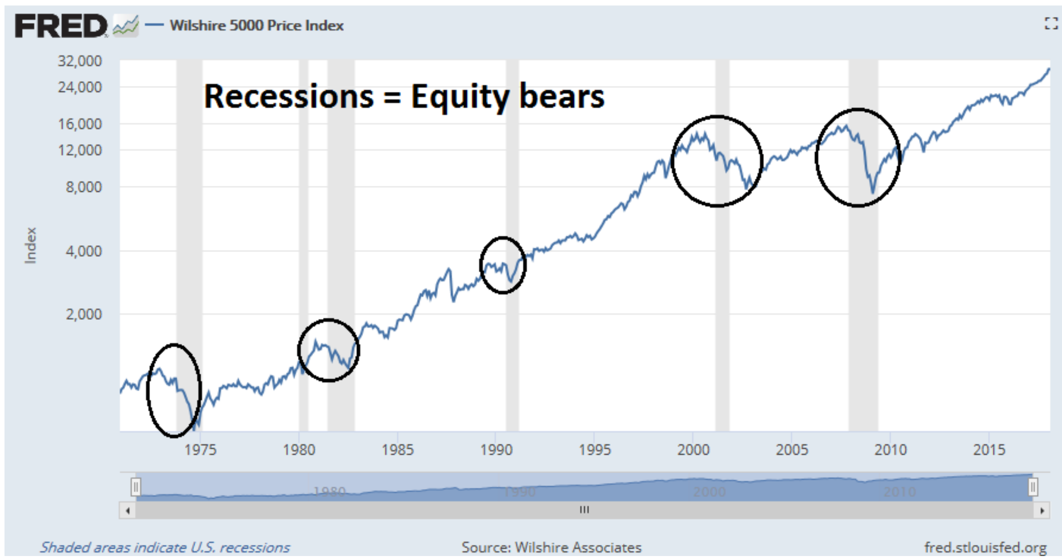
> *Market volatility has been low, meaning that stock prices have been stable for a long time.*
>
> *Some investors have interpreted this as a sign of current market risk and that there could be a sudden correction in stock markets, meaning many people could be about to lose vast sums of money.*

Should the stock market crater from here, don't panic. This is not the start of a major bear market.

No Bear Market in Sight

The following chart shows the history of major stock market declines. A bear market has either preceded or coincided with past economic recessions. If there is no recession in sight, investors should not expect a major decline to begin. The corollary lesson to this history lesson is that equity investors should be prepared for regular 10–15% corrections. If you can't stand that kind of risk, you should probably reduce your equity allocation.

Exhibit 1: Recessions = Bear Markets



Source: FRED, Federal Reserve Bank of St. Louis

Our conclusion is based on the analytical framework of the long leading indicators pioneered by forecaster Geoffrey Moore. These indicators have generally peaked at least a year ahead of past recessions, and they are divided into three dimensions to measure the strength of the economy:

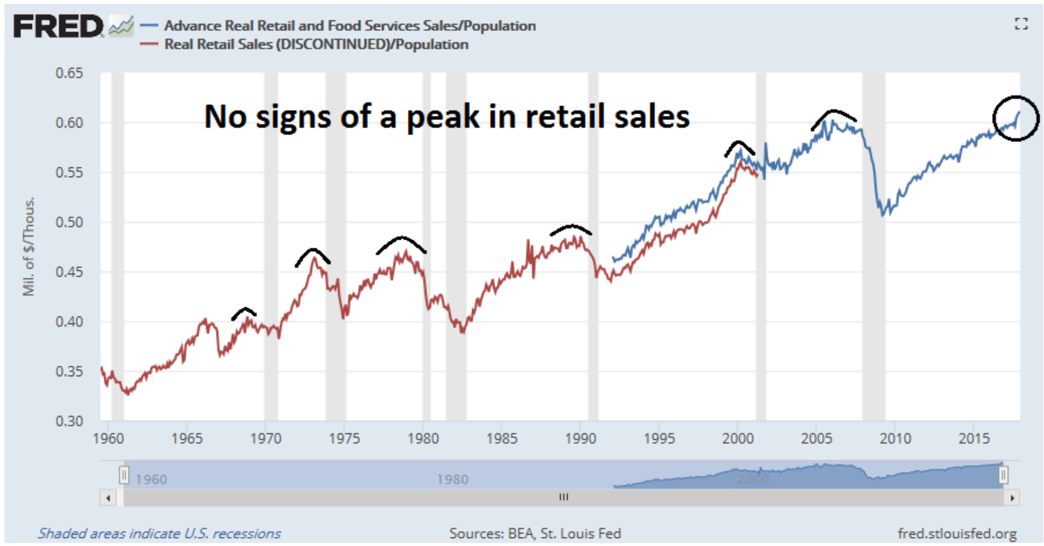
- Consumer and household sector
- Corporate sector
- Monetary conditions

As well, we consider the state of the market from a chartist's viewpoint.

Household Sector: A Late Cycle Expansion

As consumer spending accounts for the vast majority of GDP activity, the health of the American household sector is the linchpin of economic health. On the surface, the household sector looks strong. As the chart below shows, retail sales have peaked well before past recessions. Current readings show that retail sales are strong.

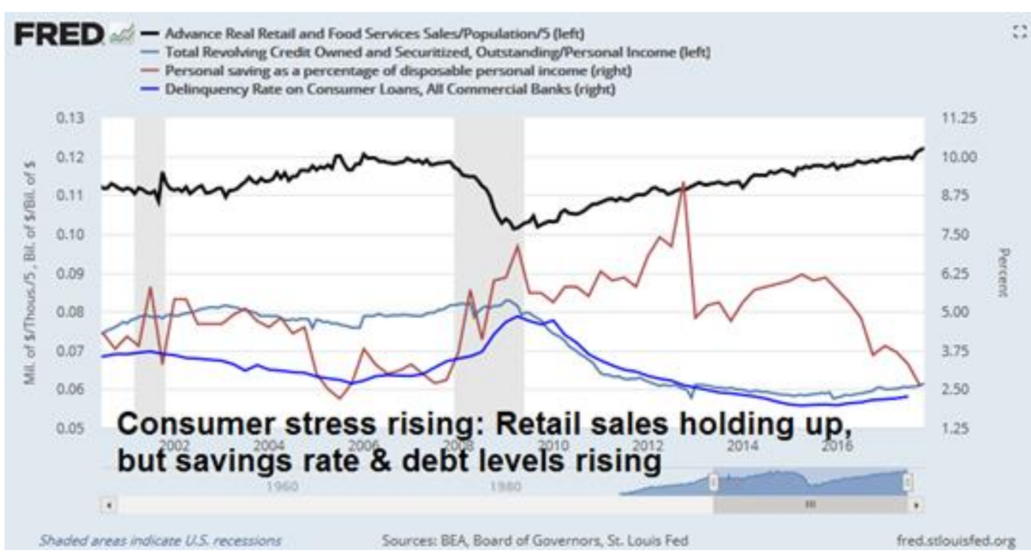
Exhibit 2: Retail Sales Are Strong



Source: FRED, Federal Reserve Bank of St. Louis

Some of the household sector internals, however, are not as healthy. Retail sales are only holding up because consumers are spending beyond their means through a combination of a falling savings rate and rising debt levels.

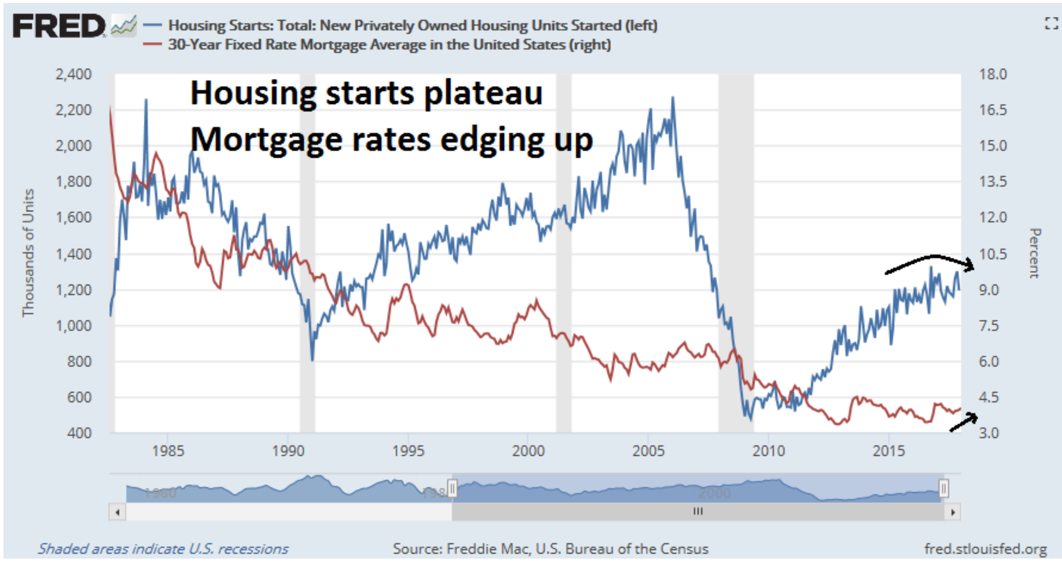
Exhibit 3: Consumers Stress Rising



Source: FRED, Federal Reserve Bank of St. Louis

We are also concerned about housing, which is a consumer cyclical and one of the most economically sensitive sectors of the economy. Housing starts appeared to have plateaued. In addition, rising mortgage rates are also proving to be a headwind for the sector.

Exhibit 4: Is Housing Peaking?



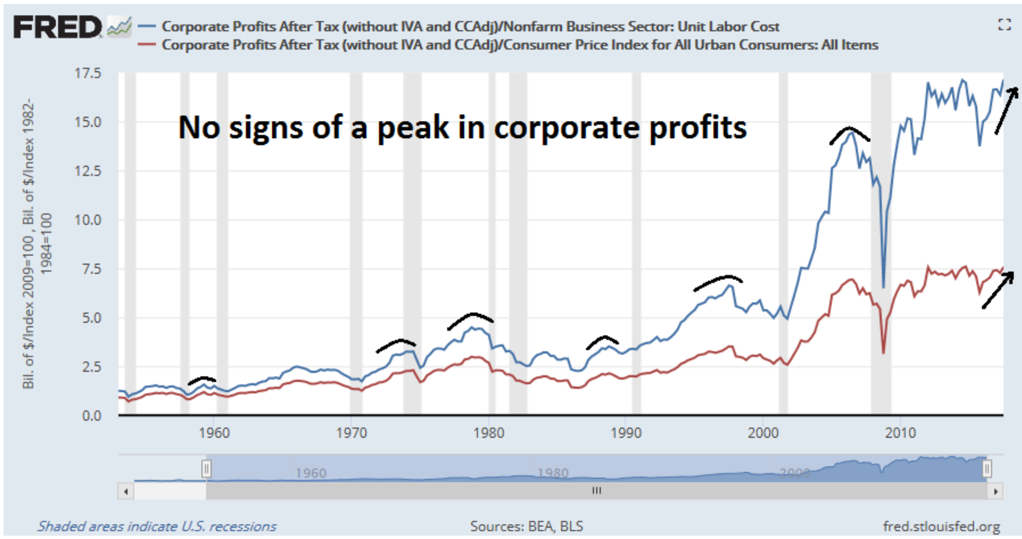
Source: FRED, Federal Reserve Bank of St. Louis

None of these readings are enough to sound the recession alarm, but they are indications of a late cycle expansion.

Corporate Sector: Strong As Bull!

By contrast, the corporate sector is much healthier than households. NIPA corporate profits have tended to peak before past recessions, and there is no sign of a peak in corporate profits for this cycle.

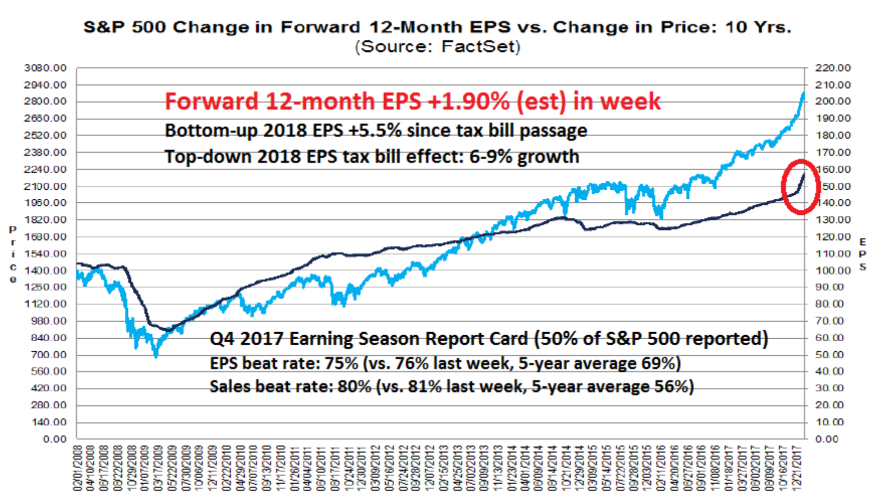
Exhibit 5: No Signs of a Corporate Profits Peak



Source: FRED, Federal Reserve Bank of St. Louis

While NIPA Corporate Profits are backward-looking statistics, the latest update from FactSet also shows that strong forward-looking profit expectations. Bottom-up forward 12-month EPS estimates have historically been coincident with stock prices, and they are rising at a robust clip. The latest round of EPS upgrades are driven by two components: a tax cut effect and a cyclical effect.

Exhibit 6: Q417 Earnings Season Showing Solid Results



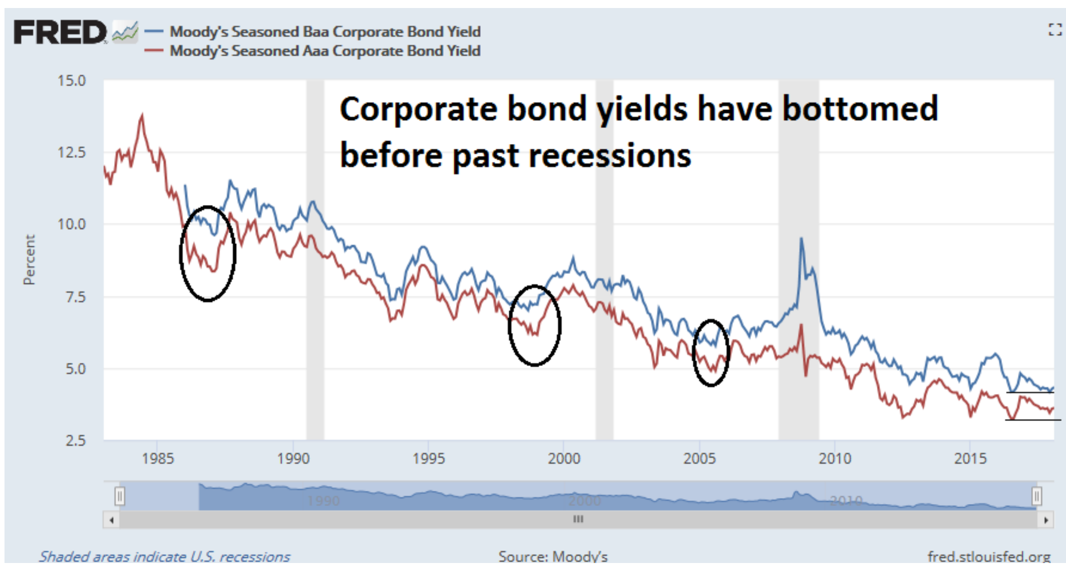
Source: FactSet Research Systems

Bottom-up analysts have been hesitant to upgrade their estimates before the actual passage of the tax bill, because they could not quantify the specific effects on the companies in their coverage universe. The latest figures show that bottom-up analysts have raised their 2018 estimates by 5.5% since the passage of the tax bill. Top-down strategists have not been as shy about estimating the aggregate tax cut effects, and most Street strategists have penciled in a 6–9% tax cut boost to 2018 EPS. This suggests the bottom-up tax cut upgrades are nearing an end.

However, the cyclical effects of earning season remains strong. Both the EPS and sales beat rates are well above historical averages. As the earnings reports were for Q417, they did not include any actual tax cut effects. These reports suggest the near-term operating outlook still looks strong.

Historically, corporate bond yields have bottomed several years before recessions. Here, the evidence is mixed. The Baa corporate yield made a marginal new low in December 2017, though the Aaa bonds did not make a low in that month and the low in August 2016 still stands for the current expansion.

Exhibit 7: Corporate Bond Yields Bottomed Before Past Recessions



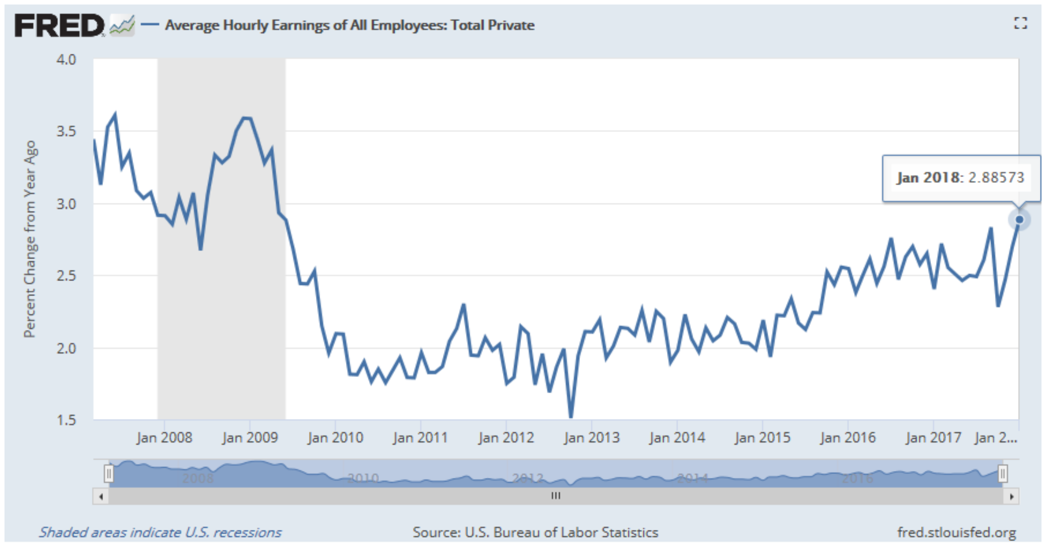
Source: FRED, Federal Reserve Bank of St. Louis

In conclusion, the corporate sector is not flashing any signs of an imminent downturn. In fact, the recently passed corporate tax cuts are likely to provide an additional boost to this sector.

Monetary Conditions: A Question Mark

Monetary conditions, on the other hand, are a question mark. The markets took fright on Friday in reaction to the January Employment Report. The headline Non-Farm Payroll came in ahead of expectations, and average hourly earnings rose to 2.9%, a cycle high reading that is indicative of rising wage pressures.

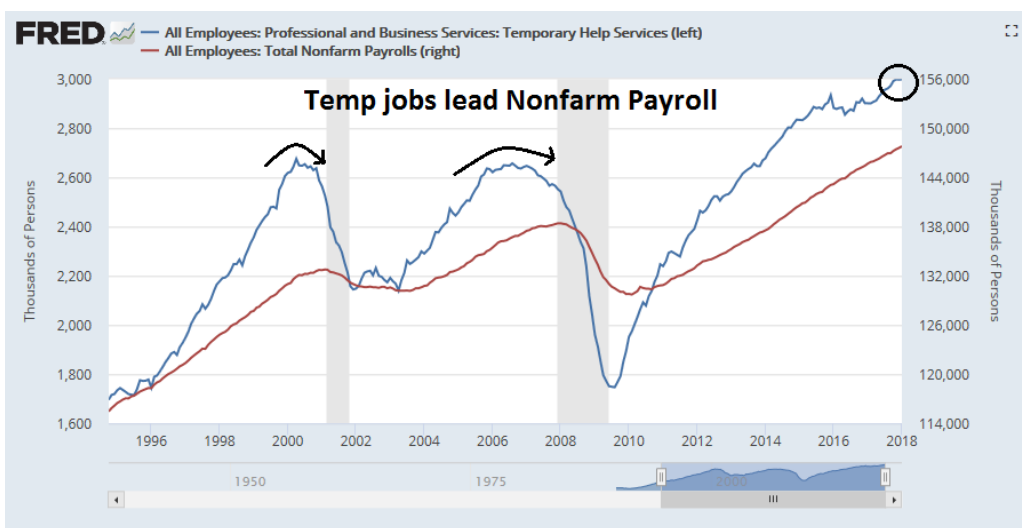
Exhibit 8: Here Comes Wage Inflation



Source: FRED, Federal Reserve Bank of St. Louis

In addition, temporary employment growth may be stalling. Temp jobs have historically led headline NFP growth, and this raises the risk that the Fed may be committing a policy error by tightening into a weakening economy.

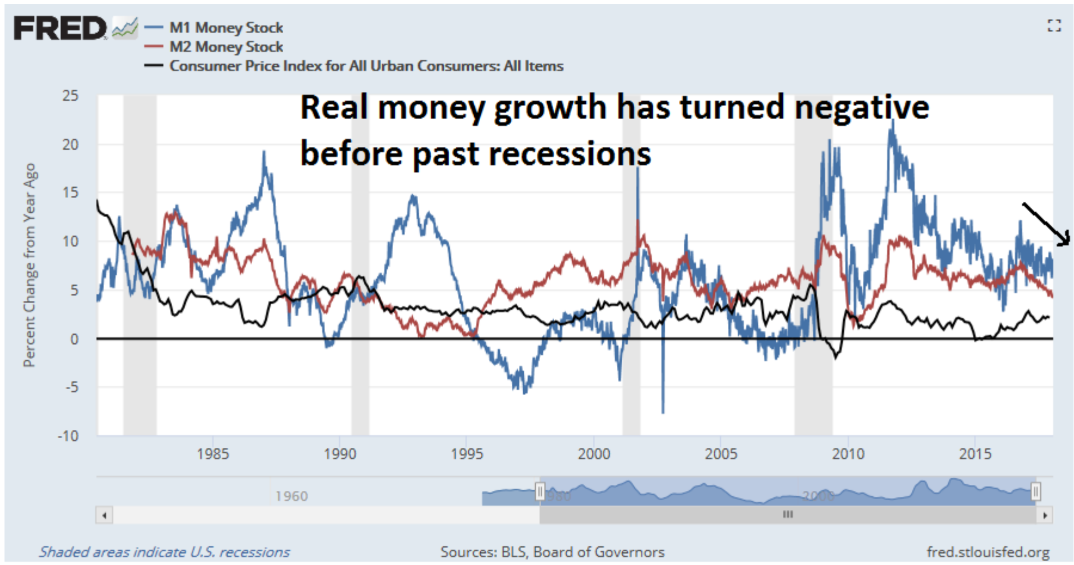
Exhibit 9: Temp Jobs Lead Non-Farm Payroll



Source: FRED, Federal Reserve Bank of St. Louis

As the Fed signaled at its last FOMC meeting that it is on track for three or more rate hikes this year, money supply growth continues to decelerate. In the past, real money growth, as measured by M1 or M2, has turned negative ahead of recessions.

Exhibit 10: Fed Policy Normalization Evident in Money Supply Growth



Source: FRED, Federal Reserve Bank of St. Louis

Lastly, no observation of monetary conditions as recession indicators without some comment about the yield curve. In the past, the 2–10 yield curve has inverted ahead of past recessions. However, the yield curve is giving unusual signals in this cycle. The following chart shows the history of the decline in the 10-year Treasury note yield from 1990. Every test of the downtrend line, with the exception of 1994–1995, saw the yield curve invert. Even though the yield curve did not invert during the 1994–1995 period, it did flatten quite dramatically.

Exhibit 11: 10-Year Yields Break Up, But Yield Curves Well Behaved

Source: Stockcharts

Friday's market response to the January Employment Report saw a dramatic rise in bond yields and a steepening yield curve. Another puzzle comes from the behaviour of the 10–30 yield curve, which has been steadily flattening to 25 bp, a cycle low.

We interpret these readings as tightening monetary conditions, but they are not indicative of an imminent recession.

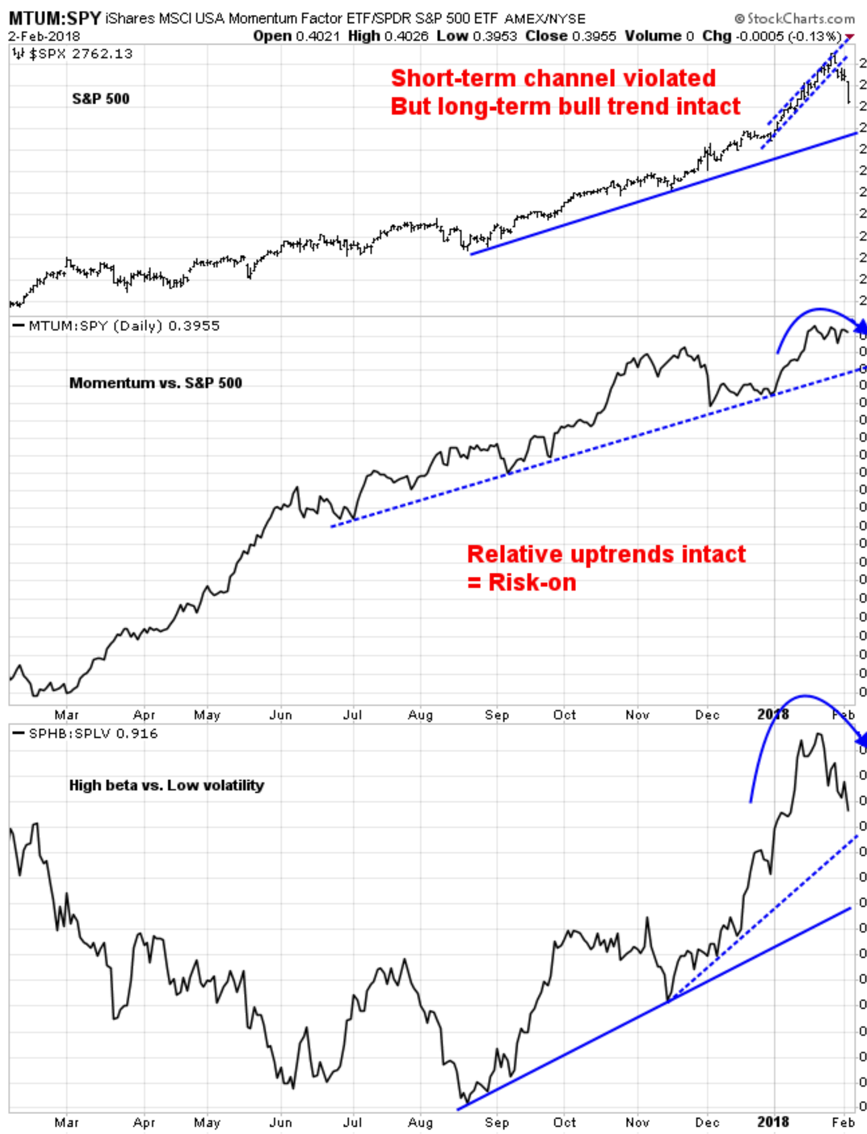
To summarize the review of macroeconomic conditions, they indicate an economy that is in the late cycle of an expansion. While conditions are deteriorating, the nowcast of 12-month recession risk is still relatively low.

Technical Conditions: Intermediate Term Bullish

Even though the latest market air pocket may appear as a shock to recent stock investors, the S&P 500 has only retreated 3% from its all-time highs, and corrections are to be expected as part of equity investing. From a technical viewpoint, the intermediate-term outlook is still bullish.

As the chart below shows, even though the S&P 500 breached its narrow rising channel last week, its uptrend remains intact. Moreover, equity risk appetite, as measured by the price momentum factor and high beta versus low volatility factor spread, remain in relative uptrends. Initial trend line support is evident at about the 2700 level, which represents a peak-to-trough correction of roughly 6%.

Exhibit 12: Risk Appetite Remains Healthy



Source: Stockcharts

For a longer-term and global perspective, past equity market tops have been characterized by double tops consisting of an initial top, market retreat and a second rally marked by negative 14-month RSI divergences. As the chart of the DJ Global Index shows, the latest correction may be a sign that the market is making the first top. Even then, investors should not panic until this technical formation becomes more developed.

Exhibit 13: Watch for Possible Negative Divergences

Source: Stockcharts

In short, the market is undergoing a garden variety correction. Equity weakness represents an opportunity to buy the dip.

However, it is likely too early to be buying immediately. Late Friday, there was some chatter by the talking heads that the market had become extremely oversold. While short-term breadth had become oversold and a bounce is likely in the coming week, there are few signs of widespread fear and capitulation that are the hallmarks of a durable bottom.

In conclusion, the latest market weakness represents an opportunity for investors to buy the dip, but tactically not yet as there may be further short-term downside risk.

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