Market Insights

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Thoughts on the Correction

Until last week, financial markets had been gaining ground progressively and had broken the record for most consecutive trading days without a 5% correction. All of that ended dramatically just before the above-consensus U.S. payroll report, which stoked concerns about interest rate rises and inflation. By February 8 the S&P 500 index was down 10% from its January 26 all-time high. The risk-off sentiment took hold globally; the United States and emerging markets have been leading the way down, with EAFE and Japan acting more defensively. Exacerbating the selling pressure has been some complacency in the markets, with big inflows into equities last year, a very strong 4Q17 and start to 2018, and volatility sellers who are being forced to cover short positions.

Putting the correction into historical context can help shed some light on its path forward. When we look back at corrections (declines of less than 20% and not associated with a U.S. recession) we see that the average peak to trough decline for U.S. equities is 13% and the duration is four months. Because the speed of the decline has been so violent we think the process to make a final bottom for equities may look like an intermediate trough, a short-covering rally on light volumes and a retest of the lows, or a classic "double-bottom" in technical terms.

When we evaluate the real economy and corporate data, we are reminded how the equity market can send false signals about economic growth. The most reliable leading indicators of economic activity, such as the global PMIs and the U.S. ISM non-manufacturing index, suggest that the world economy is firing on all cylinders. Additionally, corporate earnings revisions, capacity utilization, consumer confidence and producer prices tell us that the fundamental supports for equities remain good.

In the U.S. bond market, rates have risen relatively quickly from a low near 2% in September 2017 to a high just above 2.8% this week. That is about right in our view, considering the strength of the economy. We think the rise is a reflection of stronger growth and concerns about inflation should not be overdone. U.S. wages rose only marginally more than expected, 2.9% rather than 2.7% and do not change the broader picture that inflation in the U.S. is slowly rising, not accelerating sharply.

There are some key dates that market participants can keep a close eye on for developments going forward. Leading indicators will be released on February 20 and on February 28, the new FOMC Chairman Jerome Powell will be testifying to Congress, as annually scheduled. This will be one of his first public speeches in his new leadership role at the Federal Reserve.

It may take some time for the markets to find their bottom, but our recession indicators are not rising, our cycle indicators are not flashing warnings and our real-time activity indicators say this is a technical selling correction that will exhaust itself.

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