Stay cool

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What to make of the recent equity market correction

Last week we held our quarterly investment roadshows. Hardly were those roadshows over and we had witnessed a global equity sell-off, the worst in 10 months. For the week, the S&P 500 corrected 4.1%, the MSCI World Index lost also 4.1%, whilst the MSCI Emerging Markets Index was down 2.1%. Year to date, these three indices stand at +3.5%, -3.6% and –15.4%.

The purpose of the following considerations is to give you our view on last week's events. The October Quarterly Investment Review is with the printer, but we thought it would be a good idea to send you this update now.

Volatility is normal

First and foremost, it is important to stress that the volatility of 2018, registered in the first months of the year and now again, is normal. What is not normal is the total lack of volatility that we enjoyed in 2017.

Pressure on equities and bonds inevitable

Second, the global equity market of reference, that is the US equity market, appears overstretched. By March 2019 US equities will enter the eleventh year of the current bull market. Valuations are rich, both in absolute and in relative terms, at a time that interest rates are rising. Less quantifiable risks are emerging, such as higher oil prices, (not only trade) tensions with China, as well as growing pressures to regulate the high flying tech stocks that have driven the current bull market in the first place. This is a moment when long-term investors normally would take some risk off the table. And that is why on June 4 2018, we reduced our global equity overweight to neutral, alongside bonds, and we consequently raised cash levels.

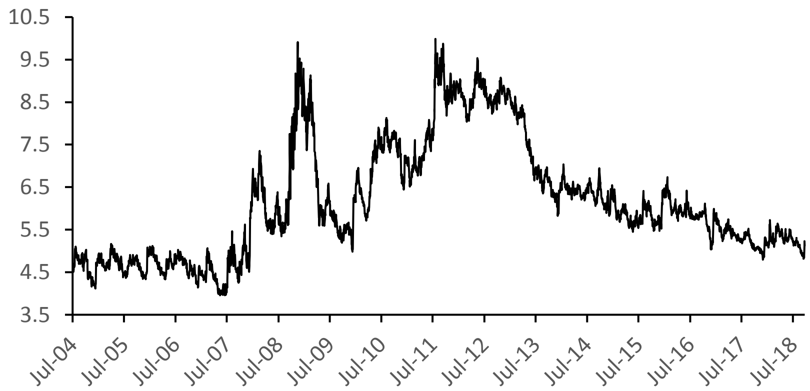
US equity market remains resilient

At the same time we stuck to our long-dating US equity overweight and Emerging Markets underweight calls (with the exception of India and Saudi Arabia), and for good reasons: the global rise in yields and the US dollar is choking off credit in Emerging Markets, not in the US. Also, earnings in the US appear very resilient. We do not expect this to change soon, as we explained during the roadshows, and as is illustrated in the upcoming *Quarterly Investment Review*.

How do we position ourselves over the next months?

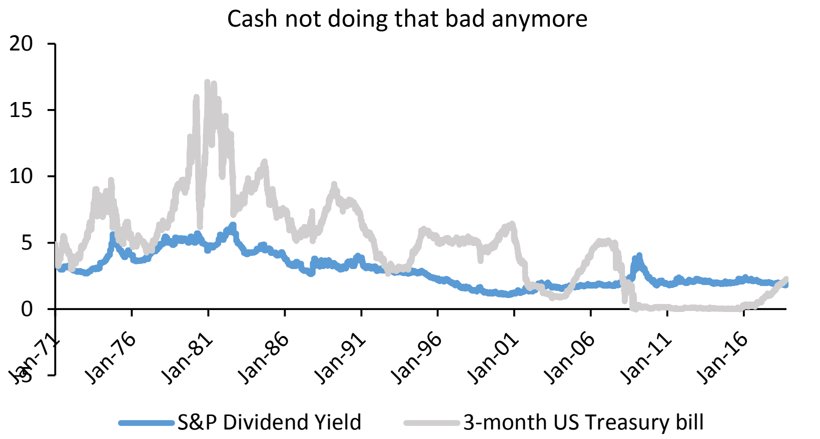
We have been stressing the risk that markets are underestimating the determination of the Federal Reserve to raise its key policy rate above 3%. Also for this reason we warned in July that US long-term Treasury yields might temporarily break-out to the 3.5% level. We now accept the risk that in fact those yields might stay at that level for longer (although in the very short term the Treasury market is extremely oversold on technical grounds, such that some reversion to a lower level is more likely in the near future). If this is true, US equity markets might correct further in order to restore the average risk premium that they have demanded over the last years.

Equity risk premium trending down with higher yields*



*S&P earnings yield based on 2019 analyst expectations minus real US 10 year Treasury yields, source: Bloomberg

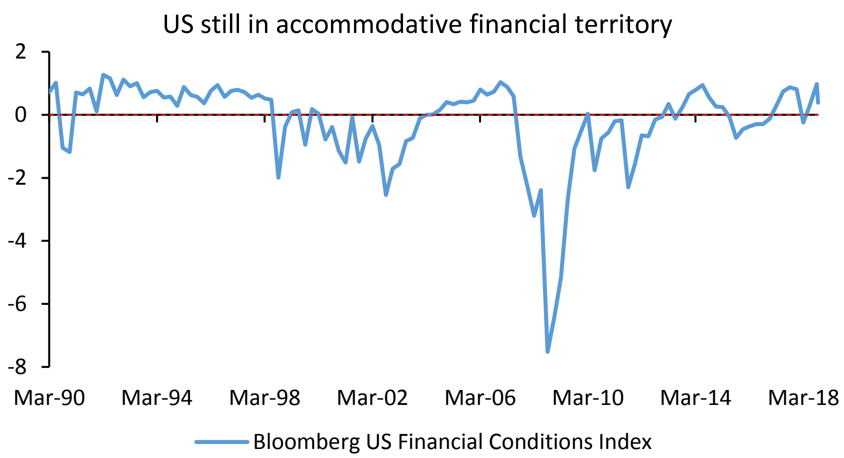
In view of these considerations, and the fact that the three month Treasury Bill now is higher than the dividend yield, our call to raise cash levels still holds.



Source: Bloomberg

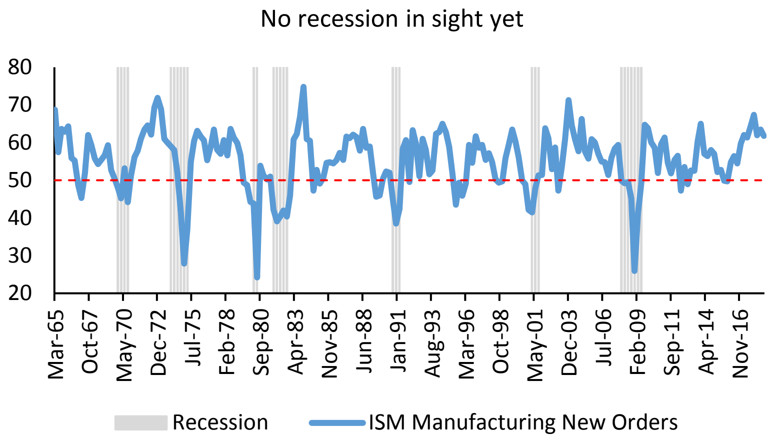
Why not go underweight in US equities?
At the same time we would like to reiterate that a US recession seems still unlikely through 2019, and perhaps a good part of 2020. It is of course extremely difficult to time exactly a recession. Yet, as tactical asset allocators we should at least try to assess the direction of economic growth, up or down. Right now the US economy appears to be speeding ahead thanks to fiscal stimulus, continuing credit growth and rising wages. There is even a chance that aggregate savings in the US, as measured by the savings over disposable income rate, could come down. Indeed, according to the Bureau of Labor Statistics, for the first time in a long while, wage growth now seems to be accelerating for the lower decile of the income distribution. This should not surprise because lower skilled wages only tend to go up when the labor market is really tight. But what really matters for us is that low income households' spending rises relatively more for every dollar of higher wage, simply because the consumption share of income is higher for these households.

As we have pointed out during the roadshows, and as is discussed in more detail in the upcoming *Quarterly Investment Review*, US recessions usually occur as a result of serious excessive credit levels in balance sheets. Today US household balance sheets are relatively solid and US corporate balance sheets, whilst more indebted than at any time since the Global Financial Crisis, appear still manageable. In other words, given reasonable debt levels, higher interest rate levels are not yet negatively impacting consumption and investment spending. The tightening policy is thus not yet reflected in credit contraction: credit is still growing and financial conditions are still perceived to be easy, not tight.

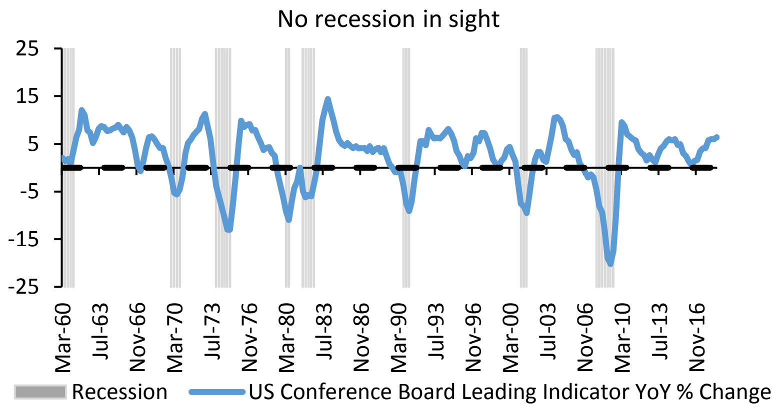


Source: Bloomberg

Not surprisingly, most leading indicators tell us that a recession is not imminent.



Source: Bloomberg



Source: Bloomberg

If our assumption is correct and US growth will remain strong through 2019, then an adjustment in relative equity valuations should provide a good entry point. Bear markets, it should be mentioned, occur typically when financial conditions are perceived to be tight, not just because those conditions are tightening as a result of the changing monetary policy. Bear markets, also, typically materialize when a recession is relatively close, not distant.

Recession	S&P 500 Peak	S&P 500 Through	Peak to-Through Declines
7/53 – 5/54	7 months before	1 month after	-12.5%
8/57 – 4/58	13 months before	4 months after	-20.3%
4/60 – 2/61	9 months before	6 months after	-12.1%
12/69 – 11/70	13 months before	6 months after	-38.3%
11/73 – 3/75	11 months before	10 months after	-53.8%
1/80 – 7/80	0 months before	2 months after	-18.2%
7/81 – 11/82	8 months before	12 months after	-29.9%
7/90 – 3/91	2 months before	3 month after	-20.9%
3/01 – 11/01	7 months before	18 months after	-50.4%
12/07 – 6/09	2 months before	14 months after	-56.1%
Average	7 months before	8 months after	-31.2%

Source: Bloomberg

Thus if US equities would correct another 10%, it would make sense to further raise our US equity allocation, and thereby we would go again overweight the overall global equity asset class.

Further ahead, at some point in 2019, we would expect the USD Index to peak at around 100. That would happen if some of the US growth spills over to Europe, and the ECB will finally start talking about hiking rates. We are not there yet, but most likely that would be the moment and the condition for us to become again bullish on the overall Emerging Market asset class.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTTNews
4. Reuters
5. Gulfbase
6. Zawya
7.

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