Market Appears to Be in a Correction, Not a Bear Market

The S&P 500 Index increased more than 57% over the past two years without an intra-period decline of more than 5.6%. We believe the recent market decline is part of a normal bull market correction, and not the beginning of a long, protracted market decline or bear market.

What's changed? We believe the overall market had been pricing in low volatility, stable interest rates, low economic growth, and sub-2% inflation. As economic growth in the U.S. and abroad has picked up, wages are on the rise, up 0.3% for January and 2.9% year-over-year. At the same time, the fed funds rate is increasing as the Federal Reserve tries to stay ahead of inflation. This, we believe, is contributing to the market volatility.

What do we expect at this time? While a bull market correction can be sharp and painful, it is generally characterized as being short-lived, typically between three to four months, before making a recovery and trending higher. One main reason market corrections are generally short-lived is that they typically occur during times when there is no economic recession. In other words, the economy is generally stable or doing well. While we have not had many market corrections in recent years, stock market corrections are reasonably frequent events. Over the long term, a 10% pullback in stock prices occurs about once a year.

What would concern us more would be the onset of an economic recession, which could then lead to a prolonged downturn more indicative of a long-lasting bear market. A bear market is when stock prices fall and widespread pessimism causes the stock market's downward spiral to be self-sustaining. Although figures vary, a downturn of 20% or more from a peak in multiple broad-market indexes, such as the S&P 500, over a minimum two-month period is considered an entry into a bear market. However, during periods of economic recessions, bear market declines historically are deeper and last far longer than corrections without an economic recession. Therefore, we believe understanding the precursors to a recession are important.

How can we tell the difference between a bull market correction and the beginning of a bear market?

1. Going back to the 1950's, recessions typically occurred after the Fed finished hiking interest rates. Today, after nearly seven years of keeping the fed funds rate at roughly 0.25% to help stimulate the economy, the Fed appears to be in the early stages of trying to bring interest rates back to a more normal level.

   To put this in perspective, the 30-year monthly average federal funds rate ended January 31, 2018, is 3.32%. Currently, the fed funds rate is 1.42%. With the 30-year monthly average at 2.3 times the current fed funds rate, it would appear that the Fed has more to go before ending its rate hikes and, therefore, we believe the chance of a recession and protracted bear market do not seem likely at this point.

2. Since 1985, there has never been a recession until we have seen an inverted yield curve. In other words, the fed funds yield is higher than the 10-year Treasury bond yield. As of today February 6, 2018, the fed funds yield is 1.42% and the 10-year Treasury bond yield is 2.75%. The difference is 1.33%, or 133 basis points. Once this number turns negative, we typically have 18 to 30 months before a recession begins.

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3. Another important sign that would suggest we are near a market peak, as well as a precursor to a recession, is when the spread between the CSI Bar Cap (Junk Bond) Index yields over 10-year Treasury bond yields widen. When this happens, it is telling us that investors are getting nervous about the health of lower quality or highly-leveraged companies. On average, our research shows this spread ranges between 2.25% and 4% during normal healthy markets. Today, February 6, 2018, this spread is 3.3%. It not until this spread widens over 4% that we would be concerned. When numbers 1, 2 and 3 above all occur at the same time, a recession has historically followed. At this point, none of these have occurred.

4. While it is true you can have a decline in leading economic indicators and have no recession, it is important to remember there has never been a recession without the leading economic indicators first going negative. As of December 31, 2017, The Conference Board's latest report shows that the Leading Economic Index is currently strong and is trending up. In other words, the U.S. economy is in good shape and is heading in the right direction. Importantly, history shows that once the leading economic indicators start to decline, there is typically a year to a year-and-a-half before the onset of a recession.

5. Economic growth is not just occurring in the U.S. but around the world. According to the International Monetary Fund's World Economic Outlook Update, January 2018, global economic activity continues to firm up. Global output is estimated to have grown by 3.7% in 2017, which is 0.1% faster than projected in the fall and 0.5% higher than in 2016. The pickup in growth has been broad based, with notable upside surprises in Europe and Asia. Global growth forecasts for 2018 and 2019 have been revised upward by 0.2% to 3.9%. The revision reflects increased global growth momentum and the expected impact of the recently approved U.S. tax policy changes.

6. According to Bloomberg, with roughly 42% of the S&P 500 companies having reported Q4-17 earnings, 81% have exceeded their estimates, the highest in seven years. At the same time, 75% have increased their fiscal year 2018 earnings-per-share projections.

7. Because inflation is very hard to predict, it requires constant monitoring. According to Bloomberg, the Consumer Price Index (CPI) inflation is currently at 2.1%. While we believe there are better measurements of inflation, we would not be too concerned about CPI inflation until it reached 3% to 3.5%. At this level, we would see it as a warning sign because our research shows that once CPI inflations gets to 4%, the P/E multiples on the stock market would have a significant pull back and would likely lead to a severe and potentially long lasting market correction. So while we are monitoring the slight uptick in inflation closely, we do not believe the current level is worrisome.

To summarize, we believe the following:

- This is a short-term market correction and overall economic and company fundamentals are generally positive and doing well.
- Inflation appears to be increasing, but at its current levels we do not see the Fed tightening so much as to cause a recession.
- We are likely to see an increase in market volatility going forward, but this should provide investment opportunities.
- As we look out over the next 12 to 18 months, we believe value-based and commodity-related stocks should benefit the most in this environment.

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