Weekly Market Flash

Inconsequential Tremors

May 19, 2017

Anyone who has lived for some time in a city like Los Angeles or Tokyo knows what an inconsequential tremor is. You feel that shaking motion, perhaps hear some objects rattling on your desk. You momentarily catch your breath, and then it's all over, usually within the span of less than ten seconds. Those inconsequential tremors happen frequently in any city with proximity to a major tectonic fault line. Only rarely – very, very rarely – do they develop into a serious earthquake capable of creating lasting damage.

Pullbacks by the Numbers

As with seismic tremors, so with financial markets. Our natural inclination is to not even categorize Wednesday's 1.8 percent pullback in the S&P 500 as a tremor. Since it did briefly puncture the preternaturally serene calm prevailing in markets as of late, though – and come as it did amidst a new level of political volatility in Washington – we think this is a good time to dust off that pullback study – long unused – and remind our clients that tremors generally do not an earthquake make.

Our standard measure for a "pullback event" as it pertains to US large cap stocks is a retreat of five percent or more from a high water mark, followed by a subsequent recovery of five percent or more. There is no higher truth associated with the five percent threshold, but we think it is a useful benchmark. A five percent decline has impact – the TV talking heads take notice and investors feel those ephemeral goosebumps – but it falls short of a technical correction (10 percent off the high) or a bear market (20 percent retreat).

By this standard, there have been 190 pullback events on the S&P 500 since the end of the Second World War, or about 2.7 every year, on average, for the 71 years between then and now. And how many times did the pullbacks metastasize into full-fledged bear markets? Well, there was a very brief bear – about seven months in duration – from the end of 1961 to midsummer 1962. There was the dismal stretch from the record high of November 1968 to August 1982, which is how long it took for the S&P 500 to forever rise above that (nominal) '68 high and bid it goodbye. And there were the two bear markets that bookended the first decade of the 21st century.

And that's pretty much it for bear markets (Black Monday 1987, yeah, but that was basically a flash crash, not a bear proper). Mostly, those pullback events are just inconsequential tremors with no particular sustaining narrative. Revolutions, it is often noted by political historians, don't happen far more often than they do happen.

Much Ado About Nothing

No two bear markets are alike, but the forces that propel them tend to arise organically from the thousands of disparate nodes of activity in the economy, and not from singular events in Washington DC. Whatever outcomes happen as a result of the current political and legal woes of the Trump administration – even the more far-fetched notions of some form of removal from office or a doubling-down of the crazy by the current residents of 1600 Pennsylvania – are highly unlikely to exert a meaningful impact on the economy at large. The slow-growth recovery continues at home and abroad. Quarterly earnings seem able to sustain at least mid-high single digit growth rates over a full fiscal year. These trends preceded Trump, and these trends seem likely to keep on keeping on.

We have no trouble imagining a near-term scenario that registers another five percent-plus pullback event in keeping with our definition above. We haven't had one since February 2016, and that's a long dry spell (remember that 2.7 events per year statistic we cited above). In the absence of any data implying a potential meaningful shift in the overall economic narrative, though, we are likely to consider any such event as yet another inconsequential tremor.

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