Weekly Market Flash

Four Takeaways from the Pullback

October 12, 2018

So here we are, with a full array of tricks and treats to test investors' nerves as the month of October gets rolling. A quick brush-up for our clients and readers on the nature of pullbacks is in order.

Since the current bull market began in 2009 there have been 20 occasions (including the present) where the S&P 500 has retreated by 5 percent or more from its previous high (translating to roughly 2 per year). Of those 20 pullbacks, four met the definition of a technical correction, i.e. 10 percent or more from the high. On one occasion, in 2011, the index fell by more than 18 percent before recovering. As of the Thursday market close, the S&P 500 was down 6.9 percent from its September 20 record high of 2930.

These things happen. As we like to say, paraphrasing Tolstoy, every pullback is dysfunctional in its own special way. With the caveat that the final word on the current reversal has yet to be written, here are four observations we think are worth keeping in mind as this one plays out.

They Finally Got the Memo

As we wrote about in last week's commentary, the market has been willfully slow, for a very long time, in accepting that the Fed really intends to raise rates consistent with its view of an economy gaining strength. Last week the bond market got the memo with a sudden midweek jump in intermediate yields. It seems that the bond market sat on the memo for a few days before passing it over to the stock market. In any case, we can say with a bit more confidence now that the memo has been received. Barring any significant changes in the macroeconomic landscape – which changes have yet to surface in the form of hard data – the reasonable expectation is for a final 2018 rate hike in December, followed by at least three in 2019.

More Bond Confusion Likely

Despite better alignment between market expectations and the Fed, we do foresee further confusion in fixed income, particularly with intermediate and long duration asset classes. Consider the multiple forces at work on the 10-year Treasury, a widely used proxy for intermediate-long bonds. Heightened inflationary expectations could push yields much higher. On the other hand, relatively attractive yields (compared to Eurobonds or Japanese government bonds, for example) could keep a lid on how high rates go. Any kind of emergent financial crisis could widen spreads between Treasuries, corporate bond and other fixed income classes.

During the economic growth cycle of the late 1990s, from 1995-2000, the average yield on the 10-year Treasury was 6.1 percent and it never fell below 4 percent. What should the "natural" yield be in the current growth cycle? Nobody, not the world's leading economists and not the trader plugging buy and sell triggers into an algorithmic trading strategy, knows for sure. We're likely to learn this from whatever we experience over the coming months, not from theoretical foresight.

Post-Sugar High Growth

Come December, we will lap the tax cuts implemented one year earlier. That will make 20 percent corporate earnings growth a thing of the past – a good part of the growth in earnings per share this year was based on the lower tax rate that flowed through to the bottom line of the corporate income statement. Right now, the consensus analyst group used by FactSet, a market research company, expects earnings per share growth for S&P 500 companies to be 7 percent in the first quarter of 2019. Now, the same consensus group predicts that top line sales for these companies in Q1 2019 will come to 6.9 percent. That tells us two things. First, it tells us that the overall global demand environment (reflected by sales) is not expected to worsen much from where it is currently. That's good news.

The second thing it tells us is that analysts will be focusing obsessively on corporate profit margins in 2019. Sales growth is good, but in the long run sales without profits are not good. Closer parity between top line growth rates and trends further down the income statement suggests that companies will need to be increasingly creative in finding ways to make money, particularly if cost pressures (e.g. on raw materials and labor) continue to trend up.

How will this factor play out? The next few weeks will be very important as the Q3 2018 earnings season gets under way. Analysts will be digesting the most recent growth and profit numbers from corporate America. The narrative could shape up positively – more growth! – or negatively – peak margin! How you as an investor approach 2019 will have much to do with whether you think profit margins really have reached their Everest once and for all. There will be plenty of excitable commentary to that effect. We suggest tuning out the commentary and paying attention to the actual data.

Leadership Circles

As in, "market leaders going around in circles." So far the industry sectors bearing the brunt of the October '18 pullback are the ones that did the lion's share of the lifting for the past couple years: tech, first and foremost, communications services and consumer discretionary. More broadly, growth stocks have been absolutely dominant for much of the latter period of this bull market. So it is reasonable to ask what might happen if the growth stock leadership falters.

We've seen this play out a couple times this year (see our previous commentaries here and here for additional insights on this topic). One of the considerations is that because the tech sector comprises about 25 percent of the total market cap of large cap US stocks, it has an outsize effect on overall direction. That works well when the sector is going up. But if, say, consumer staples stocks in total go up by as much as tech stocks go down, the net result is a down market (since consumer goods stocks make up less than 8 percent of the index). An orderly growth to value rotation might be a better outcome than outright confusion, but investors who have gotten used to the growth-led returns of recent years might be in for a disappointment.

So there's a lot at play right now. As usual, there will be no shortage of "experts" claiming to understand precisely what it all means (as they claim, after the fact, how "obvious" it was that this pullback was going to happen at exactly this time for exactly this or that reason). As for us, we simply plan on doing what we always do. Study the data, think through the possible alternative outcomes based on the scenarios we have described here as well as others, and always remind ourselves of those numbers we cited at the beginning of this commentary. Pullbacks are a fixture of bull markets and they happen for any number of reasons, logical or not. Actual bear market reversals are much rarer events. In our opinion it is not time to call an end to this bull.

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