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FIRST ANALYSIS

Institute Alert

NEWS OR EVENTS THAT MAY AFFECT YOUR INVESTMENTS

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Opportunity Amid the End of Easy

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Key takeaways

» *As of Wednesday's equity market losses, the S&P 500 Index and the Dow Jones Industrial Average had erased their year-to-date 2018 gains.*

» *We see the economy as being a long way from recession, but markets are repricing a number of key items. These include: slower earnings expectations in 2019; the delayed impacts of the 8 Federal Reserve interest-rate hikes since 2015 (and likely 4 more to come); peak fiscal policy stimulus in 2019; and a 15-month high in the U.S. dollar.*

What it may mean for investors

» *We believe that this is not the end of the cycle or bull market, and we favor deploying cash now—or even allocating incrementally over the coming days and weeks. Current conditions have the potential to create some of the best entry points into equity markets since the November 2016 elections.*

Just the facts—to start

As of Wednesday's equity market losses, the S&P 500 Index and the Dow Jones Industrial Average had erased their year-to-date 2018 gains. The Russell 2000 Index of small-cap companies is in correction territory (down at least 10% from its prior high level), with two six-day consecutive losses in October. Among the S&P 500 Index sectors, seven are in correction territory after Wednesday's action, with Materials in bear-market territory (down at least 20%). Sectors that led the sell-off included Information Technology, Communication Services, and Energy. International equities appeared to be following the U.S. markets lower as Asian trading opened on Thursday.

Sentiment turned negative at midday on Wednesday, after a sequence of news reports. These included a reported decline in September new home sales; earnings calls highlighting rising costs and trade-related supply chain concerns; lighter-than-expected Treasury auction demand; and concerns about Italian government deficits. As the S&P 500 Index fell through its October 11 low, selling programs fueled accelerating losses throughout the afternoon—under stout volume in the last hour of trading.

What happened to ignite Wednesday's sell-off?

The market is currently fixated on two familiar concerns—China trade and growth, along with the potential for indiscriminate Federal Reserve (Fed) rate hikes. Concerns about Chinese and global economic growth and supply-chain disruptions have put the Industrials sector under pressure; it is down 12% since October 3. Information Technology, another poor October performer, has the highest percentage of revenue from overseas (58%) and has an especially long period for any investor payoff.

Relative to the Fed, rising rates present greater difficulty for small-cap equities, because they carry more debt than larger companies do (as a percentage of their liabilities). Not surprisingly, small caps are down 12% over the past month as rate expectations move higher. Financials also are down 11.5% in the past month. This sector is highly correlated with global-growth slowdown expectations—through slower loan growth, tougher net interest margin spreads, and flatter global yield curves.

For perspective, other markets did not follow equities in a pattern of strong risk avoidance. Gold prices were flat, and the U.S. dollar gained little. Importantly, the Treasury yield curve steepened, which can actually be a positive sign. It would have been a more typical sign of a flight from risk if investors had bought long-maturity bonds, driving down long-term yields.

In other words, this appears to be an equity-market sentiment adjustment. It is interesting to note that, this month, the market is not rewarding earnings announcements that beat expectations—but it is severely punishing both earnings misses and lowered forward earnings guidance. What was expected to be a season of good quarterly earnings news for markets to base higher has not been met by similar market sentiment, so far.

Where do we go from here?

It will be important to watch follow-through price action and key price levels in the near term. Computerized trading models that follow algorithmic trading play a much larger role than in the past, and they can accelerate price declines when indices break below significant levels (and, conversely, they can accelerate price gains when a positive catalyst lifts prices). In the very near term, holding the 2630-2650 level on the S&P 500 Index will be crucial. Below that level, the next major price support is the February 2018 low of 2532.

Fundamentally, we see the economy as being a long way from recession, but markets are adjusting and repricing a number of key items. These include: 2019 earnings expectations of 7-9% (down from 20%); the delayed impacts of eight Fed interest-rate hikes since 2015 (and likely 4 more to come); peak fiscal policy stimulus in 2019; and a 15-month high in the U.S. dollar that will likely create headwinds for growth next year (if sustained).

All of these are challenging, but they are known and currently being priced in. What's more, continued positive earnings growth can still drive higher equity price levels. It's also worth remembering that equity markets initially fretted—but finished the year higher—even as the tapering of Fed monetary stimulus led to higher interest rates in

2013. Monetary policy transitions can be difficult, but they do not necessarily derail the economy or the bull market.

Put differently, we view this as a time to be ready to increase U.S. equity exposure, but also as what we have referred to as “the end of easy.” We believe that this is not the end of the cycle or the bull market, and we favor deploying cash now—or even allocating incrementally over the coming days and weeks. Current conditions have the potential to create some of the best entry points into equity markets since the November 2016 elections. Nevertheless, market action this year probably marks the end of the unprecedented period of low volatility and above-average asset returns across equites, fixed income, and currencies. We believe higher volatility is a healthy thing for markets, even as it adds angst for investors.

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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. Investments in equity securities are generally more volatile than other types of securities. ,

Definitions

Dow Jones Industrial Average is an unweighted index of 30 "blue-chip" industrial U.S. stocks.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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