Investment Insights

Finally, A Dip

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Highlights

- Friday saw equity markets dip, taking the current S&P 500 peak-trough decline to more than 3.5% (starting Jan. 26), marking the worst week for U. S. equities since early 2016
- Equities were way overdue for a pullback; the largest decline in 2017 was 3%, and the S&P had climbed nearly 38% from November 2016 with only the shortest, smallest drawdowns along the way. Even with this week's decline, U.S. equity markets are still up 3% on a year-to-date basis
- Healthy equity bull markets usually see periods of consolidation or even modest corrections; we view the current selloff in that light
- We would only get more concerned about our constructive equity view should U.S. bond yields continue to rise sharply enough to undermine credit markets for a sustained period, and/or if the economic backdrop were to materially worsen — neither seem likely for now

"Dow Drops 600 Points." The headline sounds terrifying, and that is its intent, because in a world in which media profitability is heavily driven by clicks and views, the more eyeballs a headline can garner, the better the article performs. What the headline is NOT clearly articulating is the fact that 600 points today is not the same as 600 points a few years ago. As a percent of the (now larger) market, 600 points today is only a 2.25% decline for the index. While notable given the recent, complete lack of market volatility, it's still a relatively small move in context of "normal" market behavior. Indeed, we would argue that periods of pullbacks and consolidation are healthy to have within a bullish trending equity market. By allowing investors to pause and catch their collective breath, new dip-buying opportunities are provided so that fresh capital can be put to work.

Since late January, equities (U.S. and globally) have been pausing, we think reasonably.

- First, economic forecasts were ratcheted up after December's tax legislation passage. At a certain point, economic surprises went from being positive to slightly disappointing versus the higher bar. One can see that in an "Economic Surprise Index" such as that created by Citigroup. It peaked on Dec. 22 and was easing throughout January. In recent years, these growth surprise trends have positively correlated with equities, as investors looked for stronger growth to boost corporate revenues and slowing growth to signal relatively more vulnerability for companies.
- Second, after the recent climb higher in stocks, some short-term technical indicators suggested the market had become ripe for a pullback.
- Third, U.S. Treasury yields rose through some much-watched technical resistance, triggering a subsequent pop higher. Just since the start of the year, the 10-year Treasury yield rose from roughly 2.4% to 2.85%. The suddenness of the move (fueled in part Friday by rising wage figures and hawkish Fed comments) likely created some concerns about corporate leverage which fed into stocks (we would note, though, that credit markets have appeared to hold up quite well through this latest period).

We, and most investors, expect inflation to increase this year. That said, reflation (rising inflation and stronger growth) has historically been positive for equities. That remains our base case.

What would concern us more is if growth lags inflation, and especially if the Fed feels the need to hike much more than expected to prevent overheating. Dallas Fed President Kaplan noted Friday that the Fed may need to hike rates more than three times in 2018. We are closely watching what might increase this risk scenario. Friday's average hourly earnings stood out, up 2.9% year-on-year versus expectations for 2.6%. However, historically wage pressures became more meaningful for the Fed and corporate profit margins when annual wage growth was closer to 4.5%-5.0%. We're still a ways off. Other risks (highlighted in our December *Quarterly Investment Perspective*): a weaker dollar and higher oil prices.

Both have been become realities to an extent. Brent crude prices, now around $69/barrel, are up some 50% since last June. Over the same period, the trade-weighted dollar has lost about 6%. At the margin, both should pass through to higher inflation (though both have also lifted energy equities and the weaker dollar has helped U.S. based multinational companies).

In the very near-term, we can't rule out that this selloff continues. The week ahead will see (again) government shutdown risks (new measures are needed by Feb. 8). Historically, equities have also tended to benefit more at the start of earnings season than at the end. However, as long as economic data continue to reinforce a "reflationary" picture, we would not see this as anything more than a much-overdue pullback.

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