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A Sharp Rotational Pull — But Not The End

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WHY WE BELIEVE EQUITY MARKETS HAVE BEEN SELLING OFF RECENTLY

U.S. stocks are down about 5 percent from their September all-time highs, with NASDAQ and Technology as one of the worst performers.

- The sell-off is driven by a sharp rotation, from high growth, high momentum, highly valued segments of the equity market to cash, short-selling fixed income and some parts of the defensive sectors.
- The high momentum stocks, such as Technology and Growth, are the areas that performed significantly better than the broader markets in the past few years.

Of course, market sell-offs are not abnormal. Typical years have multiple drawdowns of 5 percent or more. We view this as a healthy correction driven by technical factors not fundmental.

The rotational pull so far in October is driven by four main factors:

1. Concerns over a continued rise in yields across the curve;
2. Oil prices heading sharply higher, possibly toward $100 per barrel;
3. Slowing U.S. earnings growth;
4. On a longer term basis, the trade skirmish with China is heading toward a trade Cold War.

These four areas seem to be all gathering momentum, and at the same time a major U.S. industrial company warned of higher input costs due to tariffs and rising rates, and lower revenues due to the strong dollar over the past year. This has accelerated the equity market weakness since last week.

WHAT IS OUR VIEW?

Although we are long in the cycle, it's too early to call an end to the bull market, for many reasons and observations:

- Economic growth in the U.S. continues to be above trend and should not slow down as much as the consensus expects next year.
- Earnings Per Share (EPS) growth should slow from over 20 percent to around 6 percent for next year but the absolute level of earnings should not peak.
- The market has risen around 6 percent collectively while earnings are up 4 times more. So valuation has not risen dollar for dollar with the market, and is not in extreme territory overall.
- The 1.5 trillion dollar tax cut is just now feeding through in a major way into the broader economy; at the same time we are at 3.7 percent unemployment. Therefore, capital expenditure growth should remain attractive, and may grow further from current levels. As it becomes more difficult to find workers, companies begin spending to increase the output per current worker, which raises productivity.
- Secular inflation is not showing signs of increasing. Cyclical inflation is picking up but should eventually be weighed down by global demographics and productivity.
- The rise in interest rates has been driven by stronger growth and not inflation. This can cause a temporary rotation from high growth sectors to more value oriented areas.
- The fixed income yield curve has actually steepened slightly in the last week. This is counteracting the previous trend of a flatter curve, which is considered a larger worry in terms of future growth.

- The current U.S. outperformance versus the rest of the world—Technology or high growth outperformance of all other sectors—became too large and needed to correct somewhat. This is healthy.
- The Federal Reserve (Fed) is normalizing rates and remains very balanced. We do not believe financial conditions are restrictive given what we are experiencing in stress indicators, spreads, and the Gold market. Gold is not rallying aggressively and the U.S. dollar is not re-gathering a stronger bias, indicating this is more a correction of the excess in the market rather than the end of the bull cycle.

Overall, we expect the last few years of this bull cycle to produce equity returns around 6 to 7 percent annually versus the 14.7 percent on average experienced since early 2009. We would raise high quality exposure on weakness, rebalance equity exposure when extremes are built, and keep diversification at a high level, which helps protect against sharp drawdowns in concentrated exposures - whether it is in a particular region, market capitalization, style or sector. This is why our strategic allocations are highly diversified.

Mid-term elections are still a wildcard and could limit the gains in the S&P 500 above the 3000 index level, but not enough to change the overall dynamic. A trade war with China that re-organizes the global supply chain more toward the U.S. may actually be U.S. growth friendly relative to rest of the world, but could limit equity market gains.

We expect earnings season, which kicks off in the next couple of weeks, plus a more dovish Fed communication, to provide the needed optimism to stabilize the recent weakness and re-start the uptrend. Sentiment is far too weak right now, in our opinion, given the strong growth we are still witnessing.

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