October 11, 2018

RBC WEALTH MANAGEMENT

Global Insight Weekly

A closer look

Don’t be shaken by the shakeout

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A number of factors reached critical mass, driving U.S. equities and other markets sharply lower. But investors shouldn’t overreact to this overdue pullback. We don’t think there is an existential threat to the U.S. bull market, and we look at how the Fed and bond markets fit into all of this.

Pullbacks and corrections are routine when it comes to investing, but they rarely feel that way when they arrive.

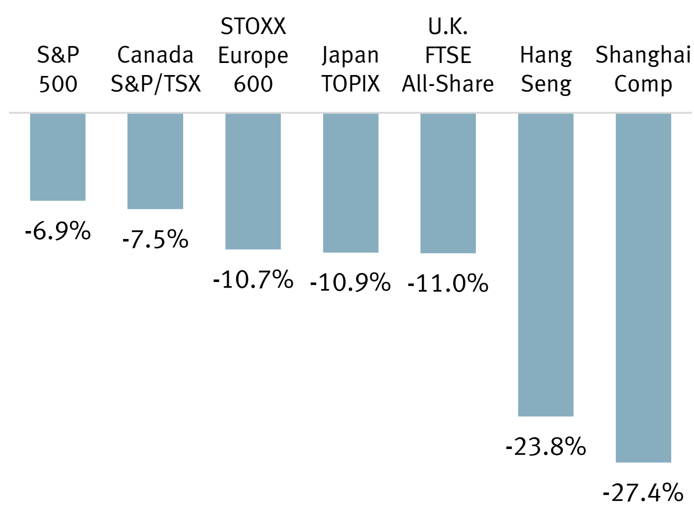
The U.S. equity market sold off on Wednesday and Thursday, marking six straight declines for the S&P 500. The NASDAQ stumbled more than the broader indexes. As Technology shares corrected sharply, the NASDAQ posted its second-biggest single-session selloff in seven years, falling 4.1% on October 10, behind only the Brexit-induced selloff in mid-2016. All total, the Dow Jones Industrial Average, S&P 500, and NASDAQ have declined 6.6%, 6.9%, and 9.6%, respectively, from their recent all-time highs.

Equity markets worldwide followed the U.S. lower, adding to their previous losses. Asian and emerging markets have borne the brunt of the global correction.

The U.S. fixed income market hasn’t been immune to the selling. Treasury prices fell and the 10-year Treasury yield climbed to 3.23% at one point, the highest level since 2011. The spike in yields spooked global equities.

The correction is weighing more heavily on Asia ex-Japan

Percentage decline of select equity indexes from 2018 highs*



*Four of the seven indexes reached all-time highs in 2018: S&P 500, S&P/TSX, FTSE All-Share (U.K.), and Hang Seng
Source - RBC Wealth Management, Bloomberg; data through 10/11/18; data in local currencies

Pointing the finger

Corrections typically have multiple culprits, and this episode is no exception. Equity markets are primarily being held back by:

- the run-up in Treasury yields and related concerns about a higher interest rate regime;
- perceptions by some that the Federal Reserve may shift to an unnecessarily aggressive rate hike pace (we disagree);
- a fierce decline in global Tech stocks primarily due to tariff risks, regulatory threats, above-average valuations, and signs of peak activity in bellwether semiconductors;

Market pulse

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Priced (in USD) as of 10/11/18 market close, EST (unless otherwise stated).
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- the increasing likelihood the U.S.-China trade dispute will intensify, and the ratcheting up of overall tensions between the two countries;
- concerns about China's slowing economic momentum;
- potential wrinkles in the U.S. Q3 earnings season related to margin pressure, tariff angst, and the strong dollar; and,
- the coming transition to a slower, more normal U.S. corporate earnings growth rate in 2019.

Data from RBC Capital Markets indicates global investors had crowded into the U.S. over the summer as tariff risks were hitting other markets with greater force. Technology and Communication Services have become particularly over-owned, and have underperformed during the market pullback. Another growth sector, Consumer Discretionary, has lagged as well.

There are also signs that computer-driven algorithmic trading may have exacerbated the equity selloffs. This is becoming par for the course during episodes of volatility.

It's important to keep in mind the S&P 500 pullback follows the strongest quarterly performance in almost five years. U.S. equities are usually volatile in October and are often wobbly in midterm election years—typically pulling back within the 12-month period ahead of the election and then rallying after the dust settles.

Market maintenance

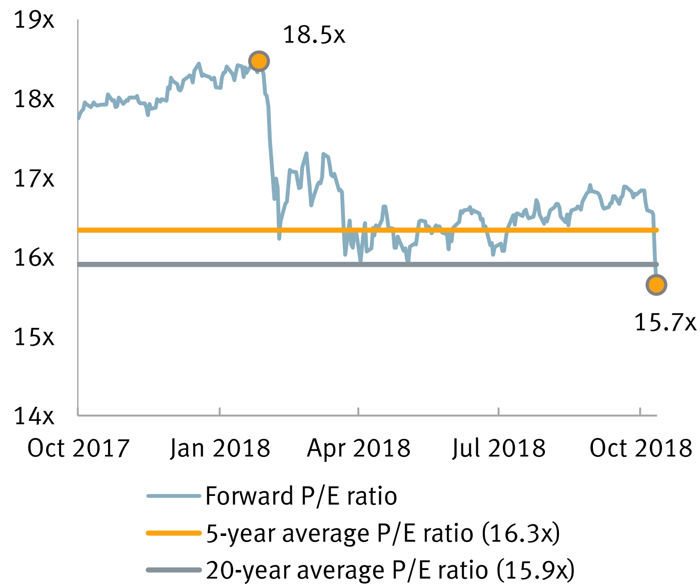
In our view, the entire laundry list of concerns above does not need to be resolved for equity markets to start to regain their sea legs. Our checklist of requirements for calmer conditions includes: Treasury yields settling down, Tech stocks stabilizing, and indications that Q3 U.S. earnings trends will be respectable overall despite some wrinkles by select companies. Some fear and loathing among investors would also help, in our assessment, as these attitudes are almost always contrary indicators. This process will likely take some time.

The immediate risks facing equities have not changed our constructive longer-term view because the two pillars for stocks—economic and earnings growth—are likely to continue to provide a sturdy foundation. We remain Market Weight U.S. equities and slightly Overweight the overall global equity asset class. Forward-looking indicators are still signaling the U.S. economic expansion will persist for the next 12 months, at least, and some of these data points have actually strengthened recently.

While we expect S&P 500 earnings growth to slow from its torrid 2018 pace of 20%+ y/y (including the boost from tax cuts), growth in 2019 should be average to slightly above average, in the high single-digit to low double-digit range.

The silver lining: Market valuations are easing

S&P 500 forward twelve-month price-to-earnings (P/E) ratio



Source - RBC Wealth Management, FactSet; data through 10/11/18

This should be enough to maintain the long-term bull market streak, in our view.

During market corrections, valuations typically ease when earnings forecasts do not deteriorate. At this stage, earnings growth is still materializing, sales growth is outpacing GDP growth, and valuations are easing. In fact, the S&P 500 forward price-to-earnings (P/E) ratio has declined. After reaching a peak of 18.5x in late January based on the twelve-month forward consensus forecast, the forward P/E has declined more than 15% to 15.7x to trade below longer-term averages. Additionally, measured against the 5- and 20-year averages, the chart shows that the current valuation appears to be relatively benign for a market forecast to grow earnings per share at 20%+ y/y for the second half of 2018 and at roughly 10% in the first half of 2019.

Passing the gut check

Over the near term, it's likely the issues weighing on U.S. and global equities will take some time for markets to sort through or adjust to, and could involve more downside.

RBC Capital Markets, LLC's Head of U.S. Equity Strategy Lori Calvasina is reluctant to buy the dip at this stage given the risks surrounding Q3 earnings season and the over-ownership of U.S. equities by global investors, and specifically crowding in Tech and Communication Services. We think earnings trends will be respectable overall with some select companies facing challenges related to margins, tariffs, or the dollar. But the process has to work through the system over the coming days and weeks.

RBC Capital Markets, LLC's Technical Strategist Bob Dickey anticipates that once the market finds its footing, perhaps at moderately lower levels, some backing and filling should occur within a trading range over the months ahead as the market consolidates the strong gains of the past two years.

Our view remains that investors should give equities the benefit of the doubt as long as the economic, credit, and earnings cycles remain favorable for stocks. We would not overreact to the recent moves. Corrections usually take some time to play out. They rarely end quickly. We think investors have time to be patient and make portfolio decisions thoughtfully, in line with long-term goals.

Welcome to the policy error era

The bond markets are again receiving the bulk of the blame for equity market turbulence, and it may not be completely unwarranted. With the Federal Reserve having raised short-term rates to a 2.00%–2.25% range at its September meeting, we are nearing the level where policy rates begin to restrict economic activity—currently estimated by the Fed to be levels higher than 3.00%, or just three rate hikes away.

While the September rate hike had long been anticipated, markets have renewed worry on the back of recent historically strong economic indicators and rising wage pressures that might cause the Fed not only to raise rates toward that 3.00% level more quickly than expected, but to push well beyond it.

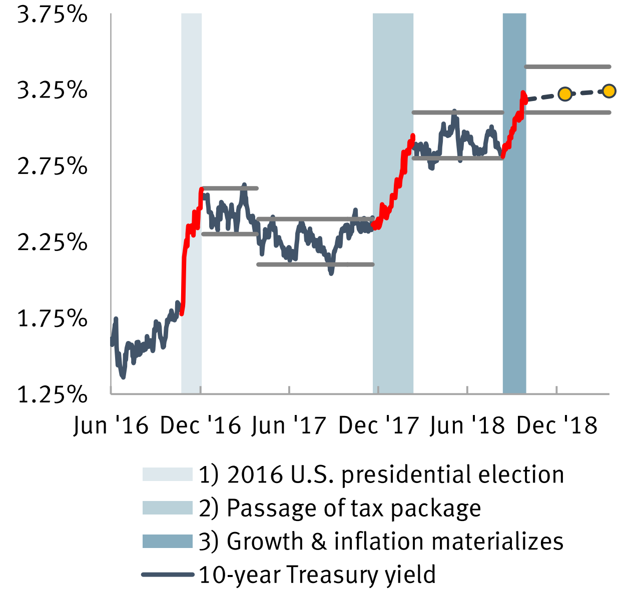
Those fears were sparked in part by Fed Chair Jerome Powell's October 3 comments. "Interest rates are still accommodative, but we're gradually moving to a place where they'll be neutral—not that they'll be restraining the economy," he said. "We may go past neutral. But we're a long way from neutral at this point, probably."

The bond market likely took issue with the Fed's decision, at its September meeting, to remove language characterizing policy as "accommodative" from its official statement as well as with Powell's suggestion that rates remain "a long way from neutral," which raised the possibility that the Fed chair thinks the neutral level could be higher than the Fed's current 3.00% consensus.

But the main problem is that while the Fed may think rates are a long way from neutral, markets continue to see policy rates peaking for the rest of this cycle at just 2.75%, or two rate hikes away.

Looking forward, we believe uncertainty around what each subsequent rate hike means for the economy, and the risk that the Fed will raise rates until something breaks, will keep markets on edge and is likely to keep volatility elevated—as is typical in a late-stage economic cycle environment.

We expect the 10-year Treasury yield to once again steady after latest selloff



Source - RBC Wealth Management, Bloomberg; 10-year Treasury yield forecasts based on futures market data

But it doesn't have to be this way

The chart shows the story of the benchmark 10-year U.S. Treasury yield over the last two years, and the three catalysts that have driven market selloffs. As in the past, we expect the 10-year yield to stabilize and find a new 30 basis points trading range, this time between 3.10% and 3.40%. However, we think this is the last hurrah for Treasury yields as we maintain our view that 3.40% is likely to be the speed limit for the 10-year in this economic cycle.

We also continue to see the Fed raising rates, likely twice more to 2.75%, before pausing. Despite recent strong data, RBC Global Asset Management expects economic growth to moderate next year, while the October 11 release of consumer price data showed inflation remains in check. That, combined with recent market action, should only serve to convince the Fed that caution is warranted.

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