

Market brief



Wealth Management
Dominion Securities

Volatility is back: What the selloff means

While the market's swoon was jarring, we believe investors should maintain equity positions, as healthy economic and earnings growth prospects provide solid underpinnings for equities.

Volatility has come back with a vengeance with the Dow Jones Industrial Average and S&P 500 each falling more than 4% on Monday after struggling in previous sessions. At its worst level, the Dow briefly dropped 1,597 points late in the session before recovering some of that lost ground to close down “only” 1,175 points. The Dow and S&P 500 are off 8.5% and 7.8% from their highs, respectively.

Historical context

A 1,175 point drop isn't what it used to be in percentage terms given the Dow is now well above 20,000. Back when the Dow was at 10,000, that same point decline would have represented a 12% plunge.

That being said, a selloff of this magnitude is rare. The last 4% single-session decline in the S&P 500 was in August 2011 when Washington dawdled about raising the federal debt ceiling, which put the U.S. credit rating at risk. There have been only six sessions with 4% or more selloffs since this bull market began in March 2009. Declines of this magnitude happened on only 145 occasions since 1929. In terms of statistical probabilities, the market's daily return was above this level 99.9784% of the time since 1929—so this was a rare three standard deviation event.

RBC Wealth Management Technical Strategist Bob Dickey wrote, “We suspect that the volatility will likely continue in both directions over the next several months, in a more normal long-term pattern compared to the low volatility of the past two years. This could take some getting used to.”

Canadian perspective

Following the selloff, the S&P/TSX Composite is down 6.6% from its 2018 high close. While the decline has been sharp, the domestic market has fared better relative to the 7.8% decline of the S&P 500. The outperformance of the S&P/TSX can be attributed in part to valuations, which are more modest in a historical context relative to those of the S&P 500. Through the recent market turbulence, resource sectors and those that have been historically negatively correlated with interest rates have

S&P 500 bull market timeline



Source - RBC Wealth Management, Bloomberg; data as of 2/5/18

S&P/TSX bull market timeline



Source - RBC Wealth Management, Bloomberg; data as of 2/5/18

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All values in U.S. dollars and priced as of February 5, 2018, market close, unless otherwise noted.

For important disclosures, see [page 4](#).

underperformed in Canada while the remaining sectors have fared better than their U.S. counterparts.

What were the culprits?

While the specific cause of Monday's decline is unclear at this stage, it was likely exacerbated by the unwinding of volatility-linked derivatives and automated program trading. It is also possible there was "forced selling" by one or more institutions. But these are symptoms rather than causes.

We think the equity market's weakness is rooted in the uncomfortable, steep increase in Treasury yields that has unfolded since December 2017 and the related potential that U.S. inflation could pick up, pushing beyond the Federal Reserve's target. This heightened concerns that the Fed could increase rates at a faster-than-expected pace in 2018.

The stock market handled this well for a number of weeks, but the meaningful jump in U.S. wage growth seemed to put an exclamation mark on these risks.

Rising rates and normalizing inflation levels do not automatically open the door to an equity bear market, but they may open the door to further market adjustments. Until the stock market has a better grasp on where interest rates are headed, there could be a tug of war between those who think higher yields are going to climb further and those who think the move in yields is overdone.

Solid underpinnings

Most important for equity investors, the market's three-legged stool remains sturdy:

- **The economy is strong:** Forward-looking economic indicators continue to suggest recession risks remain very low. This is key because it is recessions that kill bull markets, not uncertainties about Treasury yields. Eric Lascelles, chief economist at RBC Global Asset Management, believes the business cycle has further to go. He wrote, "Our latest work argues that it is still in the 'late' stage of the cycle, meaning the next downturn would normally occur within the next couple of years, but not obviously tomorrow."
- **U.S. corporate profit trends remain solid:** S&P 500 Q4 2017 earnings growth is tracking at a healthy 13.6% y/y pace, and the full-year 2018 estimate has increased substantially thanks to the corporate tax cuts. The 2018 consensus forecast stands at almost \$156 per share, or 17.9% y/y growth, up from \$146 in December. We think this estimate is achievable.
- **Market valuations have improved:** At the end of 2017, the S&P 500 was trading at 18.2x the 2018 consensus earnings forecast. The significant jump in the earnings estimate combined with the market decline has shifted the valuation down to 17.0x, a more reasonable level, and not too far from the 15.7x average of the past 20 years. Similarly, the valuation of the S&P/TSX has declined to 15.0x 2018 consensus earnings from 16.3x at the start of the year.

Current pace of realized volatility not outside normal levels of longer-term averages

S&P 500

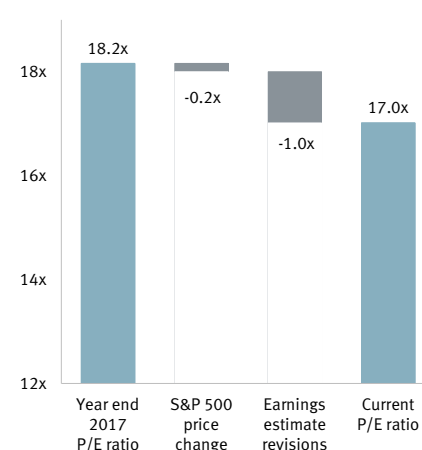
Year	# of days with moves greater than +/- 1%	# of days with moves greater than +/- 2%
50-year avg.	58	13
2018 pace*	41	20
2017	8	0
2016	48	9
2015	72	10
2014	38	6
2013	38	4
2012	50	6
2011	96	35
2010	76	22
2009	117	55
2008	134	72

* Current pace represents the occurrences to date, annualized for the remainder of the year. In 2018, we've experienced 4 days of market moves greater than +/- 1% and 2 days of moves greater than +/- 2%.

Source - RBC Wealth Management, Bloomberg; data as of 2/5/18

Market valuations decline on improving earnings estimates

S&P 500 P/E ratio on 2018 consensus earnings estimates



Source - RBC Wealth Management, Thomson Reuters I/B/E/S; data through 2/5/18

Patience is a virtue

We remain comfortable that fundamentals continue to support our modest Overweight allocation to equities relative to the long-term strategic allocation level. In addition to the support that the economy, earnings, and valuation provide, we believe monetary policies will remain relatively tame once the dust settles.

But episodes like this tend to take time to play out. Pullbacks can morph into corrections and volatility can shift back and forth for a number of months. We think investors have time to be patient and make portfolio decisions thoughtfully, in line with long-term goals.

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