CIBC PRIVATE WEALTH MANAGEMENT

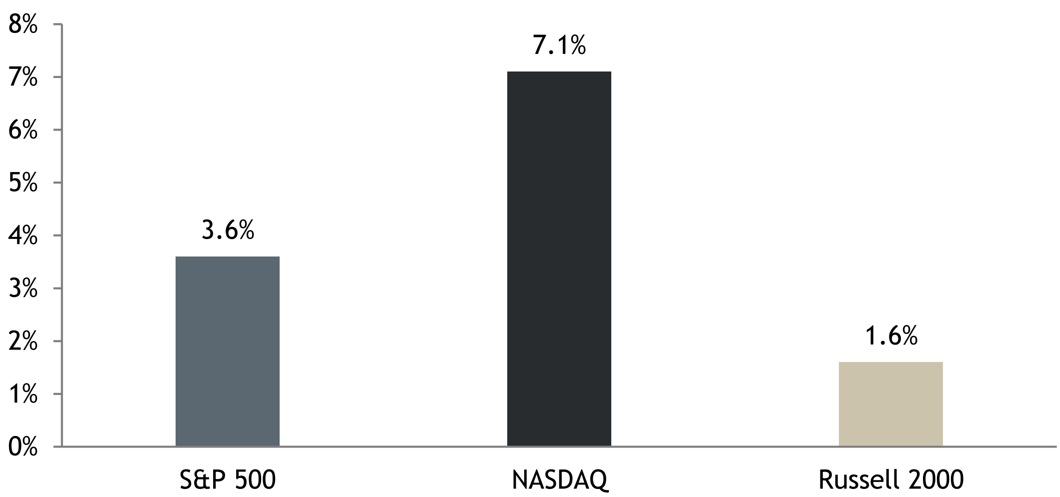
INVESTMENT STRATEGY

Volatility Returns

The S&P 500 has dropped over six consecutive trading sessions and is now 7% below the all-time high reached on September 20, 2018. This follows a strong third quarter (+7.2%)—the best in more than four years.

Here is where U.S. equity returns stand on a year-to-date basis as of the market close on October 11, 2018:

Year-to-Date Total Returns



Source: Bloomberg, as of 10.11.2018.

FACTORS BEHIND THE SELLOFF

While a spike in volatility can be unnerving, it is a normal part of the market cycle. There are myriad theories on why the strong upswing in the third quarter has abruptly reversed course in October.

We would cite two as the most dominant:

1. The interest rate outlook; and
2. Heightened concern over the U.S./China trade dispute

Interest Rates. The 10-year Treasury rose 0.25% over 14 trading sessions, hitting 3.25% on Monday (since receded to 3.14%). This was due to a rise in real yields due to strength in the economy and a more hawkish tone from the Federal Reserve. Chairman Powell made it clear that he views the economy as strong enough to handle a normalization of interest rates and that Fed policy was still a “long way from neutral.”[1]

In recent days, equity investors have shifted their interest rate assumptions higher, which implicitly argues for a slightly lower multiple on the stock market. We view this reassessment as more realistic—consistent with our view that both U.S. economic growth and inflation will run higher than consensus in the quarters ahead.

Though these bouts of volatility feel new every time, we have seen this movie before. Bond market volatility frequently precedes stock market volatility. A look back to the beginning of the year is instructive. After a meteoric rise in the first four weeks of January, the S&P 500 tumbled just over 10% in nine trading sessions. The proximate cause of the correction?—some tough talk from the Fed, an “upside surprise” inflation report and a quick 0.25% increase in the 10-year Treasury yield.

U.S./China Trade Dispute. Much of the concern has been prospective (“if the dispute drags out, it will be a problem”). However, over the last few days a small group of companies in the industrial and luxury goods sectors reported that the tariff dispute is already negatively impacting their earnings, either due to weaker demand from Chinese customers or higher input costs. Q3 earnings season has barely begun, so investors may have jumped to the conclusion that this will be an oft repeated story in the hundreds of earnings releases in the weeks ahead.

The boom in corporate profits has been the single biggest support for the bull market this year, so it’s somewhat understandable that anything challenging that optimism would cause a “risk off” impulse. It’s important to remember that most companies do not have major exposure to China, and it’s unlikely that those who do will all have a China problem starting with Q3 earnings.

While we do not think that China issues will materially detract from what should again be a very strong earnings quarter, it is appropriate for the U.S. equity market to discount more risk on the China story over the next few months. It is quite possible that after the midterm elections, the Trump Administration will ratchet up its tariff and other trade protection tools against China.

WHY HAS THE TECH SECTOR GOTTEN HIT SO HARD?

October is notorious as a "regression to the mean" month for equity sectors. Sure enough, the leading sectors for the first nine months of the year—technology and consumer discretionary—are the biggest laggards in October. Consumer staples and financials, significant underperformers for most of the year, are outperforming this month.

The technology sector has above average exposure to the two factors previously mentioned—the interest rate cycle and China. Most technology stocks are truly long-duration assets, and potentially more sensitive to fluctuations in the outlook for interest rates. Many also do substantial business in China. These risks have largely been overwhelmed by strong earnings growth, but there will now be enormous scrutiny on third quarter profit reports in the weeks ahead.

THE OUTLOOK

As always, calling a bottom to these market downdrafts is a fool's errand. We're not too far from a 10% correction and all the dramatic headlines that go along with that. Volatility may endure in the short term. It's important to remember that pullbacks and corrections are a normal part of a bull market, and that we've been blessed with precious few of them in this cycle.

This does not look like the beginning of a bear market. Economic and earnings strength, inflation that is well behaved and investor sentiment that is anything but complacent or euphoric suggest that this is a mid-course correction, appropriately factoring in two issues that were perhaps ignored earlier—rising interest rates and the economic implications of a trade dispute between the two largest economies in the world. The themes outlined in our recently published Financial Markets Monitor still apply:

- A decade after the financial crisis, the U.S. economy is in mid-cycle form. Growth is solid, and inflation is firming slightly but is close to the Fed's target.
- Other regions of the world are facing more economic headwinds than the U.S., complicated by trade frictions and China's growth and policy path.
- The Fed's course of gradual rate hikes should continue in 2019. Many central banks will likely move in the same direction, resulting in global monetary policy tightening next year.
- The impact of a full employment economy and Fed policy should produce moderately higher interest rates across the yield curve.
- Cresting of economic and profit growth over the next few quarters will probably slow, but not end, the equity bull market. ■

1 CNBC.com, 10.03.2018.