5 December 2018

Uncertainty and flattening yield curve spark US market correction

On 4 December 2018 (US time), US equity markets were sharply lower. The Dow Jones Industrial Average was down 3.1%, while the S&P 500 lost 3.2%[1]. Numerous issues were behind this drop: Technical selling, fears of a yield curve inversion, continued Brexit uncertainty, and uncertainty around future Federal Reserve (Fed) policy. In this market note, our investment teams from the US share the latest views about US equity markets and the possibility of an inverted yield curve.

A few reasons behind the stock market correction

Steve Medina, Chief Investment Officer of Global Equities, thinks there were several issues driving yesterday's (4 December, US time) drop: Technical selling, fears of a yield curve inversion, continued Brexit uncertainty, and finally, uncertainty around future Fed policy. From a technical perspective, the S&P 500 had approached key technical resistance levels after the strong rally last week. In terms of the yield curve, inversion did occur in the belly of the curve while the important 10-2 spread (10-year and 2-year Treasury spread) also shrunk[2] (though remains positive).

We wrote in a prior note the new risk that trading below the S&P 500's 200-day moving average and that "meaningful bottoms are a process involving additional time, a series of rallies and pullbacks, and ultimately price." We believe we are seeing this process in action now. Fundamentally, equity valuations remain attractive. However, on the earnings front, we expect analysts will be adjusting estimates lower as we continue to move through the end of the year and assess the impacts of actual tariffs, sentiment related to potential tariffs, and the large collapse in energy prices.

According to Medina, from an economic perspective, we continue to be in a solid yet slowing GDP growth environment. The view of our strategists continues to be no US recession in the near future. This view is supported by our Bank team who notes that the management teams they have been speaking to remain positive on the economic environment. However, our strategists would note that given the length of the cycle among other considerations, a risk that is rising for a more meaningful slowdown in 2020. These day-to-day pullbacks seem to suggest the market is a bit more worried about a higher probability challenge that may occur sooner.

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[1] Bloomberg, as of 4 December 2018, US time.

[2] Bloomberg, on 3 December (US time), US 10-year Treasury's yield was once at 3.0479% and 2-year yield was once at 2.8109%, the spread was 23.7 basis points, the spread halved to 11 basis points on 4 December 2018.

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Overall, Medina believes that we continue to be in a tug of war between a market that suffered significant technical damage, risk on/risk off geopolitical and policy events, and a reasonable growth environment with undemanding valuations. Volatility will remain a part of the equity markets landscape.

The possibility of a yield curve inversion and its market implications

Frances Donald, Head of Macroeconomic Strategy, decomposes the drivers for a dropping 10-year Treasury yield to a number of reasons: (1) falling inflation expectations (mostly oil but also weaker inflation data) and (2) falling term premium (on deteriorating sentiment). Critically, the growth expectations component of the 10-year Treasury yield is still rising and the bond market is not flagging growth concerns. Meanwhile, the 2-year Treasury appears constrained by the dovish Fed turn over the past several weeks.

We are already expecting a recession in 2020 and an inverted yield curve sometime in the next six months is consistent with that call. According to past experience, this should still give investors time to make a return from US equities, just like in 1989, 1999, 1999, 2006, and 2007[3]. That said, the yield curve shouldn't actually tip into inversion until 2019 in our view, though we are dangling very close to it. Indeed, the better recession predictors are still a good distance from recession.

It's easy to highlight the distortions at play here including, on a more short-term basis, positioning issues and momentum trades. In the bigger picture, global quantitative easing (QE), particularly from the European Central Bank and Bank of Japan, continues to create a global shortage of safe assets, depressing the 10-year Treasury yield. However, Donald is worried about being overly dismissive as markets are clearly latching onto the narrative that the inverted curve is "bad". This is an environment to tread carefully and tactically.

Ultimately, Donald thinks this is still a "Goldilocks" macro environment with subdued inflation and above potential growth through 2019. We still think rates remain contained. We are still in favour of Emerging Markets, contained rates, and a range-bound US dollar. However, more market volatility should be expected.

[3] Source: Manulife Asset Management, December 2018.

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