

October 16th, 2018

Thoughts around the recent market sell-off

With the recent sell-off, particularly last Wednesday & Thursday, I thought it would be good to provide some thoughts around it. There are a lot of different commentaries around it, but I thought that Bob Doll, the Chief Equity Strategist of Nuveen Asset Management summarized it best. In his weekly newsletter (link below), he attributed the sell-off to three distinct principal causes: new uncertainty around Fed Policy, worries over corporate earnings, and technical factors. I touch upon each one of the points below.

Earlier this month, Fed Chairman Powell said Fed policy is “far from neutral.” This comment was taken as a possibility of the Fed raising rates higher than market expectations which elevated concerns over higher borrowing costs (and subsequently an increase of the cost of capital) for businesses. Rising interest rates and higher-than-anticipated, inflation (which was one of our worries at the beginning of the year) continues to be big risks to the capital markets, as seen in the sell-off in February, and now again this year. With monetary policy getting tighter, investors are adjusting to this new environment.

We still expect to see positive corporate earnings, but it will be interesting to see how stocks are treated by investors. As mentioned above, there were some profit warnings due to inflationary concerns (rising wages, higher input costs, etc.) and the trade tensions. Earnings reports and guidance will be closely watched and companies that haven’t performed or provide poor guidance should be punished this time around. In our review meeting with AQR recently, the portfolio team told us that this year they have observed growth stocks that exceeded analyst expectations getting rewarded after earnings and not being punished when they disappointed; value stocks had the exact opposite reaction: they were punished heavily on any misses and were not rewarded for outperformance. Last week’s flight to quality perhaps is a shift in mind-set and another thing to keep an eye on, as over 75% of the S&P 500 will report in the next three weeks.

Lastly, Stan and I were in New York City last week for a series of meetings and were fortunate to be on the floor of the New York Stock Exchange for the closing bell. As the Dow and the S&P 500 were falling, this meme from earlier this year (thanks Reddit!) came to mind:



The meme is referencing the large number of algorithmic trading being done on the market, whether it's by ETFs or technical / quantitative based trading. As Stan and I were standing on the balcony, there was very little panic, and traders took the sell-off in stride. The technical factors exacerbated the selling and accelerated the losses.

Ultimately, we think that this is a normal market correction. There has been nothing substantial from an economic perspective that has forced us to re-think our thesis that a recession could come as early as late 2019. As we get into earnings season, equities should start to rise once more. We will keep a close eye on the conditions as we evaluate portfolio changes moving into the next year.

As always, please do not hesitate to reach out to any member of the ClearPath team for any questions.

Sources:

<https://www.nuveen.com/bob-doll-weekly-commentary>

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