CIO View

CIO Flash

U.S. equities under pressure

We consider the market correction to be overdone given the economic environment, but expect market volatility to persist.

In a nutshell

- U.S. equities have lost most of their 2018 gains in the course of a very weak October.
- Even though the reporting season is somewhat more mixed than expected, the overall corporate figures remain very solid.
- We remain positive on U.S. equities in the medium term, but continue to expect nervous markets for the time being.

Even before the selloff in U.S. equities on Wednesday, October had lived up to its reputation as the historically most volatile month (see Chart of the Week 10/19/18). But now even annual performance figures are being dragged into the mire.

The S&P 500 lost 3.09% on Wednesday and the Nasdaq 100 4.63%. The S&P 500 therefore slipped into the red over the year, down by 0.65%, while the technology-heavy Nasdaq is still ahead by almost 3% (using the price index in each case, i.e. calculated without considering dividend income). The Nasdaq suffered its largest daily loss since August 2011. It was the second time this year that the index dropped by more than 4%. Before 2018, it took the index a whole six years before 2018 for two moves of such amplitude. The same applies to the S&P 500, which has moved four times this year by more than 3% – which also has not happened since 2012. The increasing market volatility that we have already expected to see, is therefore now becoming evident in a striking way. But to a certain extend this only marks a return to normality. On average, over the past 20 years, the S&P 500 has suffered corrections of 5% or more around four times a year.

The reason for the correction is the coincidence of long-standing risks and short-term negative developments. The risks include the ongoing trade conflict, especially between the Unites States and China, the gradual rise in U.S. debt and interest rates, the Brexit process, the slowdown in growth in China and the situation in Italy. Anxiety about Italy has recently become surprisingly acute and adds to the array of other near-term negatives: We see mixed quarterly results combined with high expectations; weaker purchasing managers' indices in Europe, especially in Germany; tensions in the Middle East; and a weakening U.S. housing market. U.S. home sales are at their lowest level for almost two years and the ratio of home inventories to sales has reached 7.1, the highest level since 2011.

What do the economic developments and the market selloff mean for our forecasts? Most importantly, we stick to our growth forecasts for the global economy for the time being, predicting only a minor slowdown in 2019. From today's perspective though, there might be a need to adjust German growth in 2018 if the upheavals in the automotive sector that affected the third quarter can no longer be absorbed in the fourth quarter. The latest Ifo figures, too, were slightly weaker than expected, but not to a dramatic extent. In the United States, on the other hand, the most recent surveys were again quite robust and we see no need for any adjustment here.

But the markets anticipated much of the good performance in the United States at the beginning of the year in the impressive January rally. Profits and earnings estimates have risen since, while the markets are now back at the level of the beginning of the year, valuation ratios have declined sharply. The price-earnings ratio (P/E ratio) for the S&P 500, based on profits for the coming 12 months, fell from 18.1 in January to 14.8 now. In October alone, the P/E ratio fell by two points. We are therefore not concerned about valuations as such, but rather think the market is increasingly doubting the sustainability of current U.S. earnings. The consensus still expects profit growth of 10.4% for 2019, while we expect only 5.9%.

Even if we consider the recent market correction, and thus also the annual performance, to be incompatible with the economic environment, we think it's too early to aggressively expand market positions again. On the one hand, we want to assess the full range of quarterly reports to gain a better understanding of whether companies may temporarily be adopting a more cautious inventory and investment policy because of the current risks, or whether a more significant change has occurred – and caution is here to stay. Overall, we judge the reporting season to be less benign than expected, especially in Europe. On the other hand, we also believe that the market itself could remain more volatile for some time while it adjusts to a few changed parameters.

In addition, we see the U.S. midterm elections as another source of uncertainty, which won't end immediately after the election. (see our Macro Perspectives on the U.S. midterm elections). In our opinion, expectations here are rather too complacent both with regard to the election result and its significance for the further shaping of U.S. policy.

Should it become apparent, however, that the midterm elections will not lead to market perceptions deteriorating and that the trade conflict will, at least, not escalate further, we believe that a positive end to the year - in line with historical stock-market patterns - would still be possible. We are sticking to our forecast of 3,000 points for the S&P 500 as of September 2019.

Glossary

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

ifo Institute for Economic Research

The **ifo Institute for Economic Research**, based in Munich, is a leading European research institute, particulary known for its sentiment indicator "ifo Business Climate Index".

Nasdaq 100 Index

The Nasdaq 100 is an equity index which contains the 100 biggest common stocks listed on the Nasdaq composite index.

Price-to-earnings (P/E) ratio or multiple

The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

Purchasing Managers Index (PMI)

The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector in a specific country or region.

S&P 500

The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Valuation

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm’s stock price in relation to its earnings.

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