Pain is motivator as retest plays out

This is how the painful retesting process works. It currently seems like nothing can go right for the market, yet this is what typically happens in the intermediate-term bottoming process playbook. We have referred to this as the “slop, pop, and drop,” where the market: (1) makes an initial low highlighted by an extreme oversold condition with a peak in volatility, (2) then experiences a sharp oversold bounce that recoups a significant part of the decline, and (3) ends with a retest of the low that brings demoralization and apathy. Sure, there are fundamental excuses for intermediate-term bottoms, but these types of declines are more about human nature following periods of rampant optimism, historically low volatility, and an extreme overbought condition.

Putting correction into context. We often repeat that market corrections only seem “natural, normal, and healthy” until you are in one. Since the late September peak in the major market indices, the S&P 500 (SPX), Nasdaq Composite (NAZ), and Russell 2000 (RTY) were down roughly 10%, 14%, and 16%, respectively at the late October low. There has even been a more dramatic 26% pullback in the MSCI Emerging Market Index (MXEF) from its peak in late January. Although these pullbacks are very nasty, it is important to remember the SPX, NAZ, RTY, and MXEF were up 62%, 93%, 84%, and 85%, respectively over the past two and a half years. In other words, put into the context of those kind of gains, the pullbacks on paper look normal – but they certainly do not feel that way.

How do we know if the Fed Funds rate is “neutral”? With clear evidence of sharp economic slowing following the threat of even higher tariffs on Chinese goods and FOMC rate hikes, it appears the main catalyst to stabilize the market at this point in the cycle is the acknowledgement by the Fed that real rates are already neutral, and that it plans to put further rate hikes on hold. Each economic cycle since 1982 has come with a significant increase in debt, which means it takes less of a rise in interest rates to invert the yield curve and significantly slow economic activity. We surmise this using the Real Fed Funds Rate (RFFR), which has seen a lower peak each cycle since 1982 (Figure 1). In our view, this is what the Fed misses when it looks at what the neutral rate has been historically, so we use the initial inversion of the US Treasury 2-10yr Yield Curve as the signal the Fed has tightened too much. Each recession since the early 1950s has been preceded by an inversion of the curve and shutdown of credit (Figure 2). While the curve is flat, it has not yet inverted, which means the current widening of credit spreads is reacting to equities vs. leading them (Figure 3).
Figure 1: Higher debt each cycle meant lower peak in Real Fed Funds Rate

Figure 2: Yield curve has yet to invert, suggesting recession still years out

Figure 3: Speculative credit spreads to US 10-yr Treasury yield not stressed
Still lacking identified catalysts, but pain is a great motivator. With the election over, the main two catalysts that could help stabilize the markets and economy are (1) a trade agreement with China, and (2) a pause in the Fed rate hikes heading into 2019. Thus far there are no clear signs of either seeing resolution, but the weakening economic data and global stock weakness may serve as a terrific motivator as we approach the G20 meeting between Xi and Trump on November 30 and the FOMC meeting December 18-19. The market is fearful nothing gets resolved, but the worse the market and economic data get, the better.

Moving from “underweight” to “equal weight” in Communication Services sector dominated by former high-momentum Tech. In September, we identified a period that was ripe for volatility, and therefore remained underweight in the newly altered Communication Services sector that is largely driven by high-momentum Technology-related growth names such as Google, Netflix, Facebook, and Twitter. These stocks are down a median 36% from their respective 2018 peak, the excesses have clearly been relieved, and as a result the sector no longer warrants an underweight.
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Date and time of first dissemination: November 20, 2018, 11:57 ET
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Distribution of Ratings:
Global Stock Ratings (as of 11/20/18)

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<th>IB Clients</th>
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*Total includes stocks that are Under Review

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