Investment*Update*

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Putting the correction in context

Extreme investor optimism has been dealt a blow. But growth is still strong, inflation is still low, and we believe the equity-market correction is likely to be short-lived.

Investor sentiment had been extremely optimistic in recent months and markets overbought, but that is no longer the case. After last Thursday's near-4% decline, the S&P 500 is now officially in correction territory, being down by more than 10% from its record high reached on 26 January. However, in the midst of this kind of market turbulence it's particularly important to take a step back and consider the broader economic backdrop – growth is still strong and inflation is still low.

Unemployment, personal income and industrial production are running stronger than their recent history. More technically, we say that they are accelerating away from the trend, and it is this concept which forms the basis of the best barometers of where we are in the business cycle. Our model suggests the US economy is still solidly in the expansion phase.

Complacency is more to blame

The recently reported stronger than expected US wage growth (2.9%) is getting the blame as the trigger for the selling – markets were spooked by speculation that the Federal Reserve (Fed) would raise interest rates faster than previously expected. But markets were overdue a correction, with valuations becoming stretched through successive record highs over the course of 2017 and into January. Wage figures appear to have been merely the trigger.

Prior to this correction, volatility was both at record lows and well below where macro-economic and market indicators implied it should be. The sudden return of volatility appears likely to have exacerbated the selling, especially as a result of heavy losses among popular exchange-traded products designed for investors betting on continued calm. As these and similar bets continue to be unwound, the period of exceptionally low volatility is probably now behind us.

Our simple macro model signalled a pickup in wage growth had been on the cards for a while. Indeed it tells us it could go higher, but it is important not to invent a strong relationship between wage inflation, price inflation and interest rate policy which simply isn't there. The correlation between wages and inflation has been exceptionally weak, and the response of wages to low unemployment in the US has been tepid at best (see more on this relationship in our recent research report on inflation, *Under pressure?*). Policymakers at the Fed have expressed more and more scepticism about the pass-through from wages to inflation. The surprise acceleration in wage growth wasn't broad based either. Production and less senior staff didn't enjoy the same up-lift and the inflation-adjusted wages of part-time workers – who account for almost one in five of the workforce – are falling. Wealthier earners are more likely to save extra income and so don't present quite as much of an inflationary threat. We believe wage growth would have to shift up rather more dramatically to cause the Fed to put a squeeze on the business cycle this year.

The Fed has a mandate to maintain stable price inflation, and is most likely to respond to prices that it can actually do something about. Energy and food prices are beyond the control of any central bank (at least one operating in an open economy) and costs relating to housing can take an awfully long time to adjust. When we strip out these three sectors, consumer price inflation is running at a paltry 0.7% – worryingly low, not worryingly high.

Financial conditions suggest caution, but recession is unlikely

While other economic growth indicators have been robust, some indicators of financial conditions have been sending a different signal – not outright bearish, but definitely rather less bullish. The yield curve, which describes the yield differential between various long and short-dated US Treasuries, has narrowed ('flattened' in market parlance). The narrowing in this proxy for the gap between return on capital and the cost of capital suggests slower growth ahead. The same is true for other monetary and credit indicators.

The yield curve and other monetary and credit indicators give a much longer 'lead' on economic activity than the strong survey evidence, such as purchasing managers indices. And this is one of the reasons we cited for being neutral on equities at the end of last year, prior to the recent correction.

Still, these indicators never suggested a recession was on the cards this year, and bear markets don't tend to come without recessions. In fact, the yield curve has also stopped flattening, with 10-year yields rising 0.2 percentage points relative to 2-year yields (significant in this context) in the past week. That's a good sign.

Rathbones
Look forward

We're confident that macroeconomic conditions will support equity market returns this year, but we are very conscious that the structure of US firms may have made them more sensitive to higher interest rates. There has been a dramatic rise in corporate borrowing: the median leverage of firms listed in the S&P 500 index is almost as high as it has ever been over the last 30 years.

For over 5% of S&P 500 firms, earnings before interest and taxes have been less than their interest payments for more than two consecutive years. While 5% may not seem a lot, it is abnormal for it to be that high during a period of economic expansion. One of the unfortunate side effects of the period of extraordinary quantitative easing that followed the global financial crisis – as necessary as it was – is the creation of an increasing number of such 'zombie' companies reliant on ultra-low interest rates. This leaves little room for the Fed to raise interest rates without pulling the plug on their life support.

Another factor contributing to our more cautious stance heading into the new year was a deterioration in earnings revisions and breadth. But 80% of US companies have beaten their fourth quarter earnings expectations, and earnings revisions and breadth in the US have shot out the lights in January as tax breaks recently passed into law made their way into forecasts. Still, we take analysts' upgrades with more than the usual pinch of salt, noting the lack of dispersion in their forecasts – they're all going up. This is another sign that too much complacency may have crept in.

Complacency is the crucial factor

We believe this over-complacency is probably the crucial factor in this correction. Equity market corrections greater than 10% are very rare during the expansion phase of the business cycle. The underlying economic data suggests that this time shouldn't be any different. Of course, rising monetary policy is going to be difficult for markets to digest, given higher leverage and zombification. But we don't see a real squeeze coming this year and if this correction has helped remove some complacency that may be a good thing.

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