ClearBridge Investments

October Volatility Not Atypical

October 12, 2018

Key Takeaways

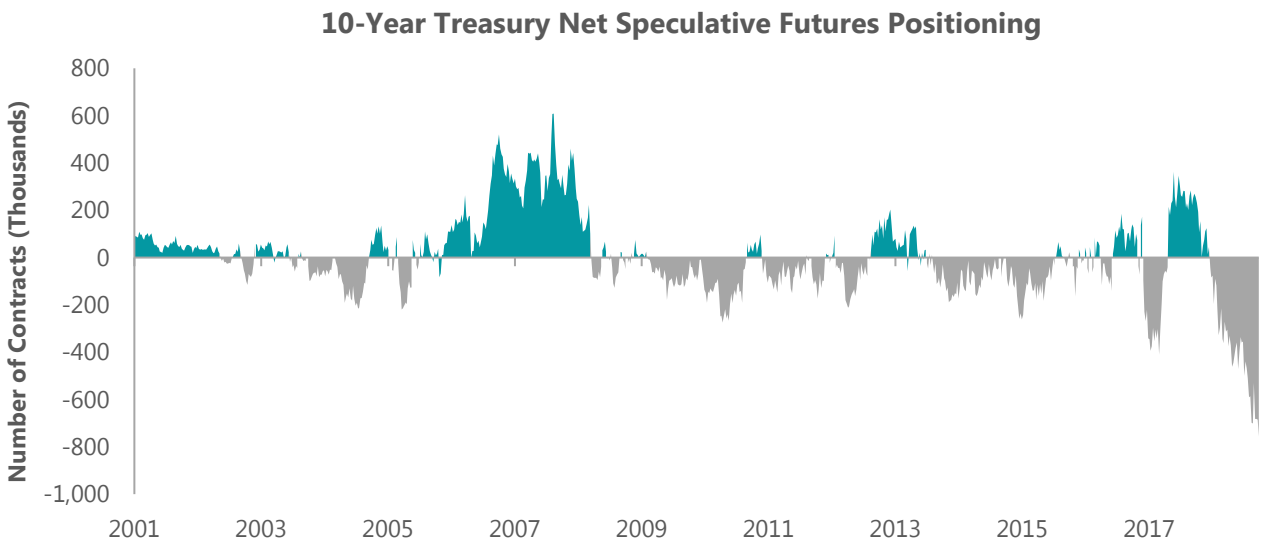
- Many investors expected a pickup in volatility heading into midterm elections, but the disproportionate move in equities relative to other risk assets leaves us optimistic about the market.
- Recessionary risks currently remain dormant and we believe the pullback this week represents an attractive entry point for longer term investors.
- The market's historically positive pattern following midterm elections and a potential uptick in share buybacks could drive stocks higher into year-end.

Higher Interest Rates a Culprit in Latest Equity Drawdown

The S&P 500 has sold off by -6.4% since its peak in late September, with the bulk of that downdraft occurring over the past few days. While some have pointed to rising interest rates and trade war tensions as an explanation for this drawdown, sell-offs typically do not have one single catalyst. While the catalyst may be unclear, we do know that many investors expected a pickup in volatility as the midterm elections drew nearer. However, the move in equities appears disproportionate relative to the moves in other risk assets. For example, while credit spreads have modestly widened, the magnitude has been much smaller than what might be expected given the decline in equities. Importantly, the ClearBridge Recession Risk Dashboard remains unchanged, and we are incrementally more optimistic about stocks in the wake of this bout of volatility.

The market experienced a -3.3% decline on October 10, representing the largest pullback for a single trading day since February and the third daily decline of 3% or more this year. This equals the total number of days with -3% or greater declines from 2012 through 2017. *Historically, when these large drawdowns have occurred during market uptrends (S&P 500 above its 200-day moving average), they have represented buying opportunities*. More specifically, the market has risen over the following one, three and six months by an average of 1.7%, 6.6%, and 10.7%, respectively when these instances have occurred going back to 1950.

Exhibit 1: Treasury Positioning



As of Sept. 25, 2018; most recent data available as of September 30, 2018. Source: CFTC and Bloomberg.

One potential culprit for the recent surge in volatility is higher long-term interest rates. Higher Treasury yields have been linked with both the current pullback (10-year yield +30 bps in six weeks) as well as the correction in January/February (10-year yield + 55bps in two months). Although we believe the longer-term trajectory for yields will be higher in coming years, investor positioning should keep interest rates in check in the near term (Exhibit 1). This is important as the market has time to digest this new reality. At present, Treasury futures positioning is at record short levels. Historically, when positioning moves to an extreme, there is typically an unwind in the other direction. Such a scenario would result in investors buying Treasuries to cover their short futures positions, pushing yields modestly lower.

As we look ahead toward the end of the year and into 2019, we remain optimistic about equities for several reasons, many of which we highlighted in our recent market commentary The Long View: Current Expansion Headed for the Record Books. Additionally, we see two important catalysts for equities as we move forward from here.

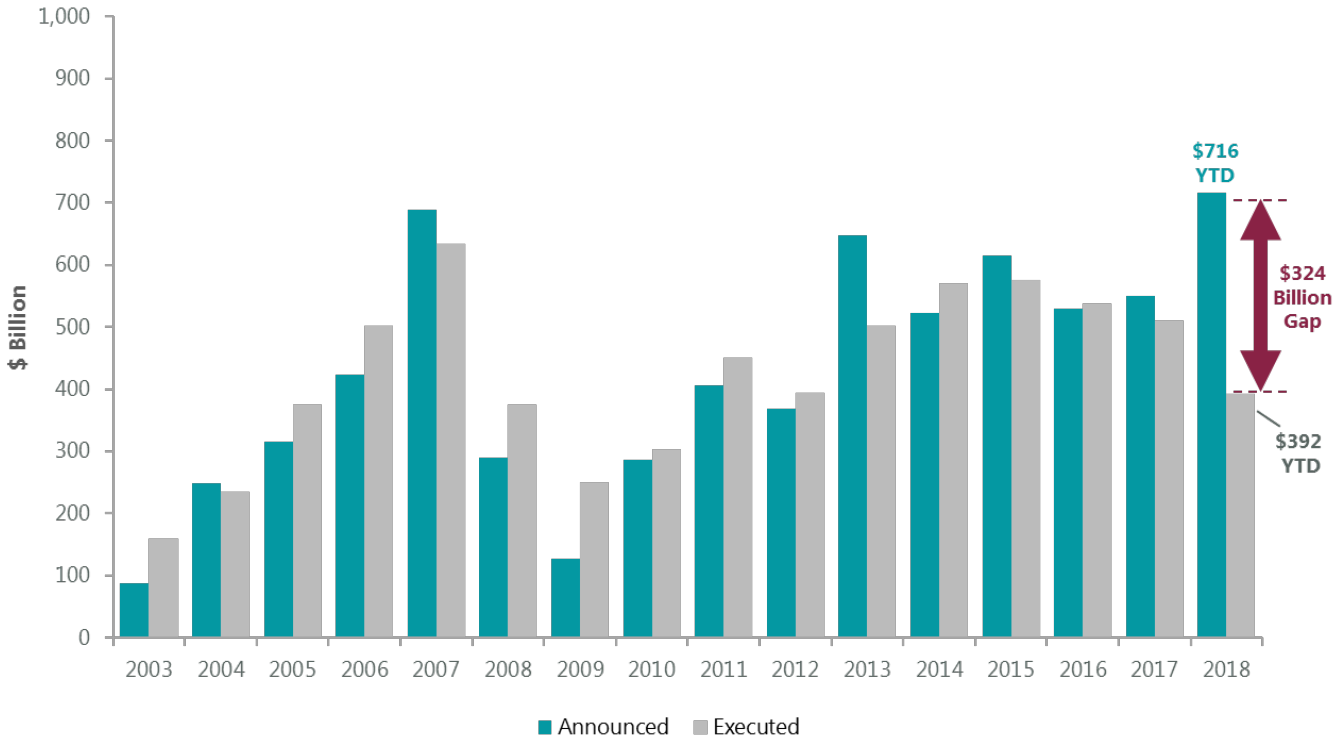
Exhibit 2: Midterm Election Year Performance

Source: Strategas Research Partners

The first is the market's typical behavior in midterm election years. Historically, markets have trade largely flat ahead of midterm elections. After the recent pullback, 2018 is following this pattern with the S&P 500 now up just 2% year-to-date. The silver lining is that midterm election years tend to be back-loaded, with strong returns in the final few months of the year (Exhibit 2). In fact, the fourth quarter has returned 5.1% on average over the past 17 midterm election years. As we gain greater certainty around the outcome of the midterms and the market refocuses on the strong fundamental backdrop, we believe stocks will ultimately follow the typical pattern and rally into year-end.

The second positive catalyst for stocks is the large gap between buyback authorizations and executions. While $716 billion of buybacks have been authorized so far this year, just $392 billion have been executed, a gap of $324 billion (Exhibit 3). With earnings season kicking off in force today, companies will be in their blackout periods over the next few weeks. However, this gap should shrink by year-end as companies exit those blackout periods and take advantage of the recent sell-off to repurchase shares at more attractive valuations. Given the large amount of available dry powder for corporate buyers, this should provide strong support for equities over the next several months.

Exhibit 3: Buybacks Should Drive Markets into Year-End



Data as of September 30, 2018. Source: JPMorgan.

While pullbacks like the one experienced this week can be frightening for investors, we believe it is important to distinguish between signal and noise. For the time being, recessionary risk remains dormant which is why we believe the current pullback — which may not be over quite yet — represents an attractive entry point for longer term investors. As monetary policy continues to normalize, and the economic cycle matures, days like those experienced earlier this week may become more common. However, the end of the cycle appears to remain in the distant future, allowing investors plenty of opportunities to take advantage of these periods of market anxiety.

About the Author

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- 13 years of investment industry experience
- Joined ClearBridge Investments in 2014
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