ClearBridge Investments

October Update: Volatility Not Atypical

October 25, 2018

Key Takeaways

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

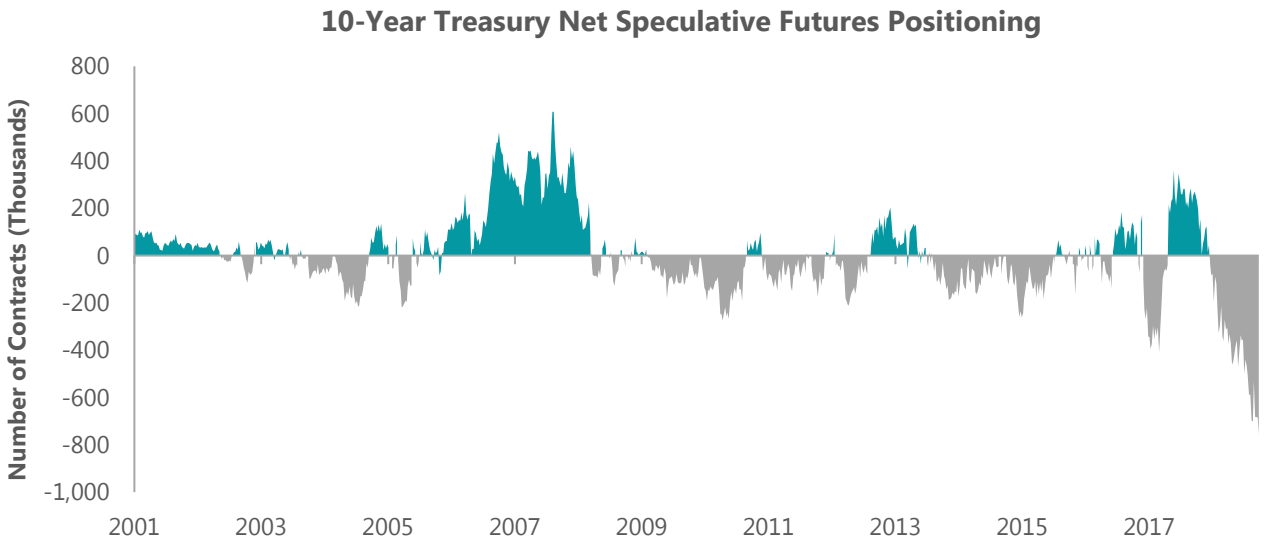
Growth Fears, Higher Interest Rates Spur Latest Equity Drawdown

The S&P 500 has sold off by -9.4% since its peak in late September, with selling pressure picking up again this week after an initial downdraft earlier in the month. 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 widened, the magnitude has been smaller than what might be expected given the decline in equities.

Importantly, despite some blame for the sell-off being attributed to fears of slowing global growth, we still maintain confidence in the current U.S. expansion. The ClearBridge Recession Risk Dashboard remains unchanged, and we continue to view this increased period of volatility as a buying opportunity.

The market experienced a -3.1% decline on October 24, representing the second largest pullback for a single trading day since February and the fourth daily decline of 3% or more this year. This exceeds 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 eight weeks) as well as the correction in January/February (10-year yield +55 bps 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). In fact, since the initial bout of selling earlier this month, 10-year yields have remained relatively flat. 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.

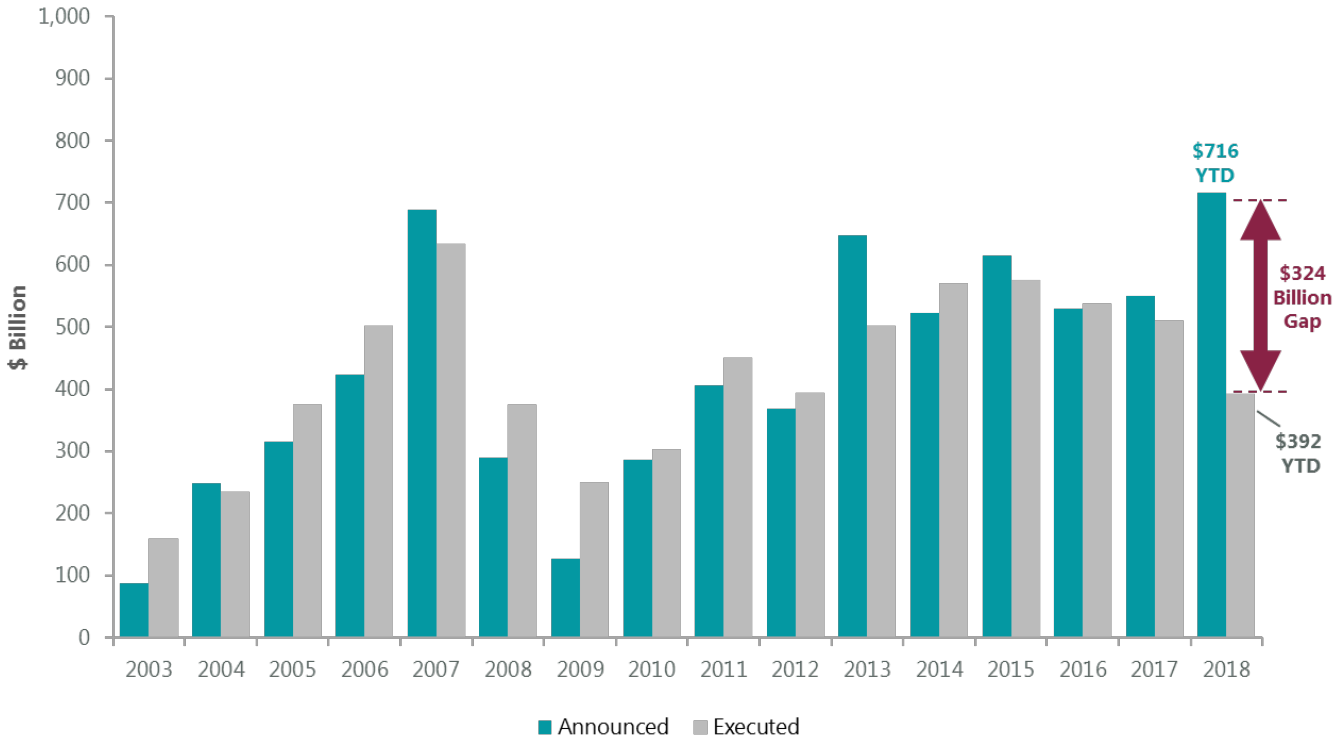
Exhibit 2: Midterm Election Year Performance

Source: Strategas Research Partners

The first is the market's typical behavior in midterm election years. Historically, markets have traded largely flat ahead of midterm elections. After the most recent pullback this week, 2018 is following this pattern with the S&P 500 now down slightly 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 in its busiest period this week, companies will soon be exiting their blackout periods. As a result, this gap should begin to shrink as we expect indiscriminate buying to occur as companies execute their announced buyback plans with many of their stocks cheaper by 10% or more. Many corporate management teams will be very excited about this development and, given the large amount of dry powder available, 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 the series of pullbacks we are experiencing this month 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 negative October stock market action — 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, months like October 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
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