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Thoughts on the October Correction

While Halloween is at the end of October, for most equity market participants, the month has been full of fright. The equity markets are in full correction mode as we write. This correction was most likely driven by valuations and maybe a little bit of seasonality. Q3 performance was strong in domestic equity markets and just like after a strong performance in Q4 of last year and January this year, the markets became slightly overbought. That pendulum has swung the other way very quickly this month and is entering an oversold condition by our estimation. The S&P 500 has officially entered correction territory (down 10% from recent peak) and some global indexes are in bear market territory (down 20% or more from peak). Timing a turn in the markets is always difficult but below are some reasons why we think this is an expected correction that is shaking some frothiness out of equity prices.

Market liquidity seems okay to date with trading flows stable and little noise about both equity or fixed income bid/ask spreads being an issue. Exchange Traded Fund (ETF) trading issues have been non-existent and trading orderly. We have yet to hear any news of issues in hedge funds or more esoteric fixed income products like Collateralized Loan Obligations (CLOs). Bank liquidity is the best it's been in decades as capital positions are much stronger than past cycles, due in large part to regulation imposed after the 2008 recession.

Credit spreads remain tight despite widening out about 50bps since the equity correction started. We would need to see high yield bond spreads widen out 200 basis points or more from the bottom to drive concern about underlying credit issues bubbling to the surface. While regional banks' loan growth has slowed, they have yet to show any stress from a loan performance standpoint. Again, if we see a much larger swing in spreads it would be more of a worry. To date, the spread move has been very orderly.

Valuations have receded significantly and for a number of benchmarks we are now at or below long-term averages. Even trailing earnings multiples are now close to long-term averages. Valuations had been running above averages in the U.S. for most of this year and some high-profile tech companies are still elevated. However, given the current level of interest rates, overall market valuations are starting to look attractive.

Earnings growth is still strong and this correction probably has more to do with adjusting expectations about future earnings. For companies that have reported this quarter, earnings growth is robust and most likely we are on pace for the 3rd quarter in a row of 20%+ earnings growth. The concern moving forward is that this level of growth is most likely unsustainable. Our view is that true growth is not going to fall off a cliff and turn negative. With stock valuations coming in we are getting to a point where valuations will properly reflect the correct stance on future earnings fundamentals. While coming into the month the pendulum may have swung too far to the bullish side; as we move through this correction, the pendulum seems to be swinging too far in the opposite direction.

Risks present today such as trade, mid-term elections, future GDP trends and further geopolitical noise are not going away anytime soon. We focus a great deal on balancing returns and risk in light of these potential market overhangs. As the correction moves forward, we are not trying to time a turn, but we believe prices are starting to better balance risk and return for those investors with a long-term investment horizon.

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