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Correction Risk in Context

Our weekly view on asset allocation.

27 September 2021

A Swift Recovery in an Unusual Market

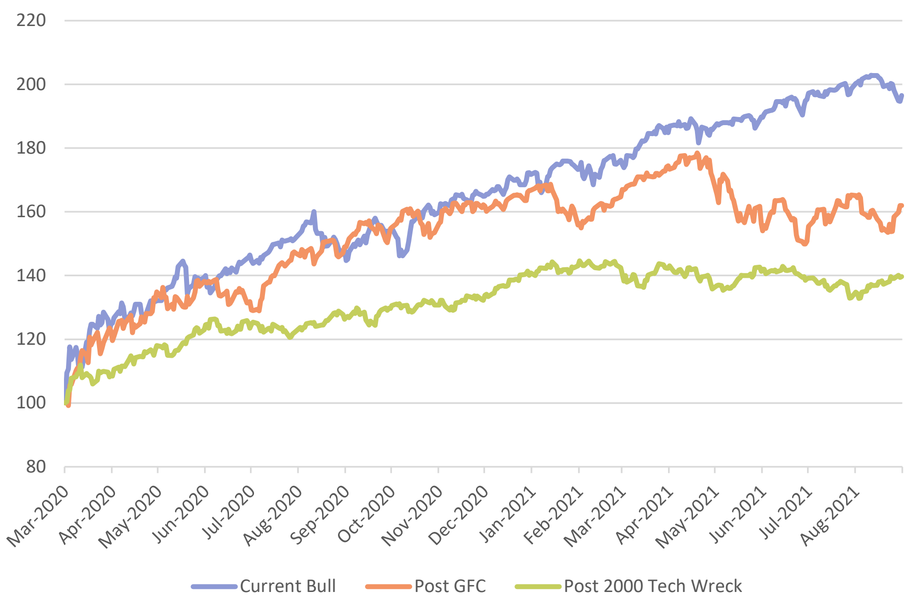
Equities have made a stunning recovery from the COVID-19 induced lows of March 2020. In the space of 18 months, US stocks have climbed 96% (US$) while Australian stocks have climbed 61%. The COVID-19 bear market was itself unusual in terms of seeing a peak to trough decline lasting only one month.

While the recovery has been fast, this bull market is also somewhat unusual due to the lack of any meaningful correction/s a full 18 months into the new upswing.

In terms of month-to-month performance, the US market has produced three minor negative months. The largest monthly fall was September 2020 at -3.9%, while Australia has seen only one negative month (September 2020 -3.8%) since the March 2020 lows.

Similarly, meaningful peak to trough falls have been virtually non-existent so far in this recovery. Daily data reveals the largest US peak to trough correction since the March 2020 lows has been 9.6% (within September 2020), while Australia has only experienced one peak to trough fall of greater than 5% (-6 % late August to late September 2020). Even in strong bull markets, this lack of corrective action is highly unusual (albeit not unprecedented in history).

Exhibit 1: The current US bull market is faster and steadier than the previous two



Source: Refinitiv, Wilsons.

Exhibit two shows that in the last bull run in shares (from March 2009 to February 2020), corrections in the order of 10% or more occurred in most years. However, the Australian market did manage a 3-year run between late 2015 and late 2018 without a meaningful correction. In a similar vein in the previous bull run, the Australian market managed a 3-year period from the March 2003 lows to mid-2006 without a 10% correction.

So, while a correction feels overdue and overdue in a central case statistical sense, it is not a certainty of occurring anytime soon, based on analysis of the past two bull markets. Of course, investors need to accept that corrections are part and parcel of equity investing, even in extended bull markets.

With volatility rising and a growing "wall of worry", a number of commentators (admittedly some have been calling for a correction for more than a year) have been suggesting it may finally be time for the market to see at least a significant pullback. Distinguishing common corrections (~10%) from much rarer bear markets (20%+) is easier said than done, but it is important, as panicking on the back of a short-lived bull market correction can be costly.

The September-October period has historically been a seasonally weaker period for stocks, so this arguably adds weight to the correction scenario, but this is often followed by a strong run into year-end. Therefore, timing corrections is extremely difficult both in terms of when to sell but also when to buy back in.

September has so far been choppy, with the market falling 4% from its early month highs (September 21), but at this point it is still well short of a correction by any definition.

Exhibit 2: ASX200 corrections are relatively common, bear markets less so

Source: Refinitiv, Wilsons.

Wall of Worry Seems to be Building

The pick up in market volatility this month has coincided with a seeming growing list of investor concerns. Outside of seasonal or technical (overbought) influences, the recent increase in volatility seems to stem from five main concerns:

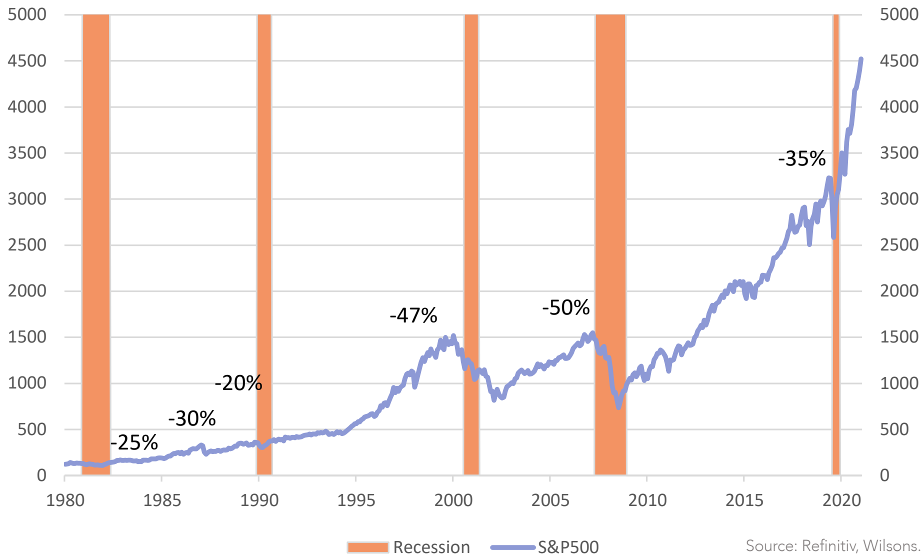
1. Withdrawal of monetary stimulus i.e. beginnings of QE tapering.
2. Concerns around a protracted stalemate in respect of the US debt ceiling.
3. The increasing potential for a lift in the US corporate tax rate and capital gains tax rate.
4. The passing of peak momentum in the global growth cycle.
5. Concerns around the China economy/ financial system, most recently the focus on the potential collapse of property developer Evergrande.

In short, we do not see any of these, or indeed the combination of these concerns, as the likely catalyst for the transition to a bear market (a 20% decline or more).

A ~10% correction due to these concerns can not be ruled out, particularly given the market has run so hard and is "overdue" for a pullback. Still, we do not think it is wise to "position" for a correction by aggressively selling stocks and significantly raising cash levels.

We still have a constructive 12-months on global and local equities with at least an average return expected (~10%). Moreover, we still see the risks around this expectation as skewed to the upside given the supportive growth and policy backdrop.

Exhibit 3: US bear markets have typically been accompanied by a recession (except 1987)



Source: Refinitiv, Wilsons.

Major (20%+) market downswings typically occur in concert with, or just ahead of, a US/global recession and almost always after considerable policy tightening. Importantly valuation stretch itself is rarely the catalyst for a bear market. The US tech bear market is probably the closest to a valuation-driven bear market, but even the tech wreck of 2000 closely preceded a US recession in 2001. In any event, as we have stated in previous research, we think valuations are still quite defendable when calibrated against current interest rates.

Equity Outlook - Correction Possible but Good 12 months for Stocks Still Probable

Our still constructive 12-month view is based on several factors.

Global/US recession risk still appears very low given a combination of pent up demand and very supportive policy settings. We expect above-trend growth over the next 12 months, at a minimum, which should be supportive for risk assets.

The ongoing pandemic is proving to be a partial headwind to economic growth, particularly given the increased transmissibility of the Delta variant. However, **vaccines are still proving very effective, and the global recovery is continuing to broaden.** Our own domestic recovery has been thrown into reverse by the NSW/VIC lockdowns, but the recovery trend should start to re-establish from mid-October as reopening begins.

QE tapering in the US looks set to begin in November, but US monetary policy is still a very long way from tight. The US official cash rate is still not expected to see its first lift until late 2022 or early 2023. Once again, this reinforces that **we are a long way from the tight policy backdrop that typically ushers in bear markets.**

Inflation is a key medium-term risk to monitor, but the near-term inflation picture is likely to be benign. **The last two monthly readings in the US show an easing in the transitory inflation pressures** that built up as the US economy began to reopen. We will continue to watch closely for evidence of more durable inflationary pressures as the economic cycle progresses over the coming 12-24 months.

Confirmation of an increase in the US corporate tax rate in the next few months should not be a surprise to the sharemarket though there might be some knee-jerk negativity if and when it is confirmed. The corporate tax hike proposed has already been watered down from 28% to 26.5% and is likely to settle at 25% (up from 21%). The direct drag on US profits will only be about 5% at worst, with US corporations adept at tax minimisation.

There is much uncertainty about how China's Evergrande situation will be resolved. This could cause more near-term weakness in sharemarkets, though **we do not see Evergrande as a Lehman Brothers moment** with direct global exposure to Evergrande debt relatively small in the context of the global financial system. Knock-on effects to the broader China property market financial system and economy are a risk, but China's policymakers have dealt with significant financial insolvency issues several times in the past. We expect ultimately China will pragmatically engineer an orderly restructure in the coming weeks if need be.

While the Chinese authorities are trying to avoid their previous playbook of aggressively stimulating their way out of a problem, China is still likely to provide a degree of policy stimulus to support growth into year-end and 2022.

So, despite risks, our 12-month outlook for global and local shares remains positive. While our positive tilt to equities could shift if the facts change, we do not see the necessary catalysts at this juncture. As almost always the case, a well-diversified and well thought out balanced growth portfolio is the best approach for most investors.

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