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Thoughts on the US Stock Market Correction

Our weekly view on asset allocation.

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Some Historical Context Around the US Correction

After a powerful rally from the 2020 COVID lows, equity markets have had a rough start to the year.

The US market in particular has experienced a sharp performance reversal and is currently down 18% from its early January peak (as at May 18). Australian equities have fared better, albeit they are still 7% lower from their early January high.

The US market's 18% decline puts it close to the technical definition of a bear market, a decline of 20%. We have examined the history of significant "corrections" and "bear markets" over the past 50 years to provide some perspective around current market weakness.

Examining the History

Significant corrections and outright bear markets are part and parcel of stock market investing. The sharp reversal in US market performance and the potential for a 20% peak to trough decline is undeniably unnerving for investors. However, historical analysis suggests this technical definition of a 20% correction as a "bear market" does not, in itself, have huge significance for providing a guide to equity market prospects over the coming 12 months.

A 20% decline in US stocks, if it occurs, will attract plenty of "bear market" media commentary. Still, our analysis suggests a ~20% decline in US (or Australian) stocks is actually more likely to be followed by above average 12-month gains, rather than another year of losses.

Big bears and baby bears

In short, baby bear corrections around the 20% level are about as common as big bears (which we define as 25% or more). Over the past 50 years, the US market has produced 5 baby bears and 6 big bears previous to the current ~18% correction.

Figure 1: US equities major corrections and bear markets past 50 years

Major corrections and bear markets	% fall	Months	Performance 12 months after 20% fall*
Jan 73 - Oct 74	-48	21	-27
Sep 76 - Feb 78	-19	17	13
Nov 80 - Mar 82	-24	17	31
Aug 87 - Dec 87	-31	5	23
Jul 90 - Oct 90	-19	4	31
Jul 98 - Oct 98	-19	4	39
Sep 00 - Jul 02	-48	18	-3
Oct 07 - Mar 09	-55	18	-29
May 11 - Oct 11	-19	5	27
Oct 18 - Dec 18	-20	3	37
Feb 20 - Mar 20	-34	1	59
Jan 22 - ?	-18	?	?

*market low used for corrections less than 20%

Source: Refinitiv, Wilsons

Figure 2: Australian equity bear markets over the past 50 years

Bear markets	% fall	Months	Performance 12 months after 20% fall
Jan 73 - Oct 74	-58	21	-38
Aug 76 - Nov 76	-23	3	8
Nov 80 - Jul 82	-41	20	-13
Sep 87 - Feb 88	-49	5	6
Aug 89 - Jan 91	-32	17	10
Nov 91 - Nov 92	-20	12	54
Feb 94 - Feb 95	-22	12	16
Mar 02 - Mar 03	-22	12	24
Nov 07 - Mar 09	-53	16	-38
Apr 11 - Sep 11	-22	5	10
Apr 15 - Feb 16	-20	10	19
Feb 20 - Mar 20	-37	1	53

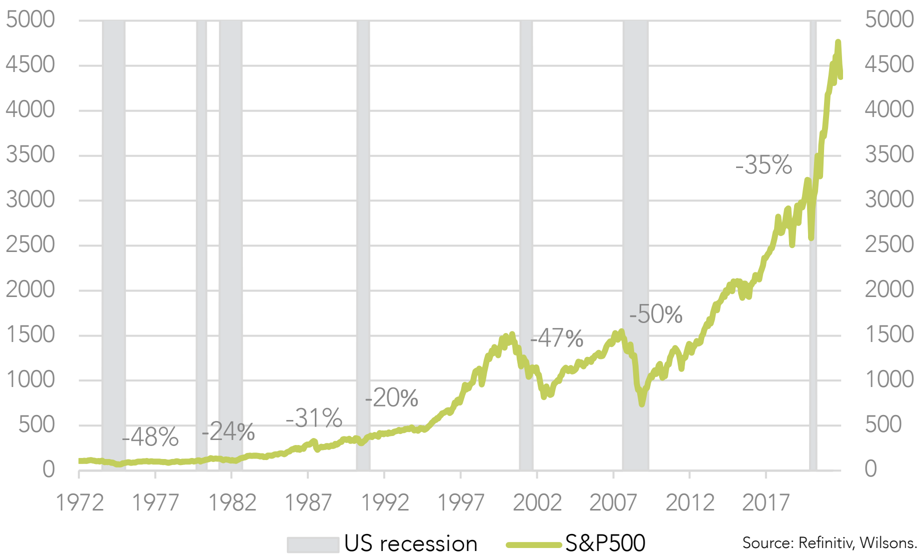
Source: Refinitiv, Wilsons

Australia has experienced 12 corrections of 20% or more in the past 50 years, which is slightly more than the US. Six have been baby bears and 6 have been big bears.

The 6 major US bear markets have generally coincided with Australia's big bears, although the 2000 US tech wreck was a milder drawdown in Australia's case.

Based on history, a 20% correction may be the precursor to a genuine bear phase, but it may also represent the tail end of a correction phase typically followed by a significant rebound. We find the most common distinguishing feature between corrections or mild bear markets and the big US bears is the onset of a US recession. For the US market, 5 out of 6 of the big bears were accompanied by the onset of a US recession. The exception was the 1987 crash. The US market fell 31% peak to trough (including a 20% 1 day fall) but was not accompanied by a US or global recession. 1987 was a dramatic decline, but the US market did regain its previous high relatively quickly. The 1987 crash was a more harrowing experience for the Australian market, with a bigger fall and a slower recovery. The onset of an Australian recession seems less clear as a guide to the size of the bear market in Australia, with a US recession (or soft landing) usually the more important marker.

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

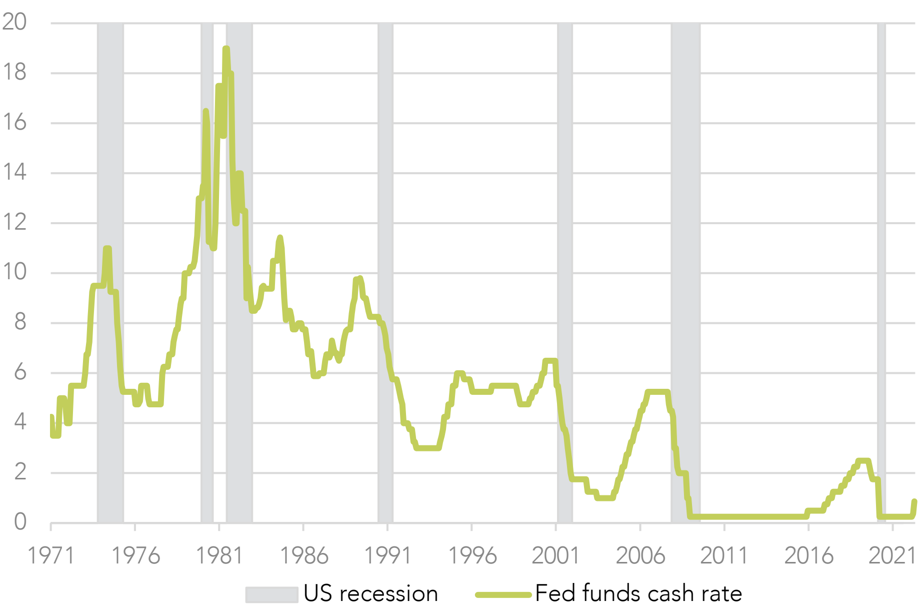


Source: Refinitiv, Wilsons.

US Recession or Soft Landing Likely the Key

In general, we believe the ability of the US to avoid recession will be vital to how the US (and our market) perform over the next 12-18 months. Our central case remains that the US economy can avoid a recession next year as fading in inflation allows the Fed to avoid overtightening. There are, of course, risks around this central case, with inflation currently proving stubborn and external tail risks coming from the Russia/Ukraine war and China's COVID dilemma.

Figure 4: The US seems a long way from recession but the Fed's "soft landing" record is far from stellar



Source: Refinitiv, Wilsons.

It is somewhat comforting that the US economy is so far proving resilient with ongoing solid growth momentum. However, there is still significant uncertainty around how the US economy looks a year from now as policy tightening works its way through the economy.

We think the US economy should be able to take higher rates in its stride, given its underlying strength stemming from very low unemployment and strong household balance sheets. As a result, we see a decent prospect for a soft landing next year. However, the US stock market is currently looking fragile and could overshoot to the downside near-term. We do think a soft landing for the economy would ultimately deliver significant rebound potential for the US stock market over the coming year.

We also expect the Australian economy to show resilience to at least moderate (~2%) increases in interest rates. The local stock market is also looking relatively resilient given its different sector mix. The economies in Europe and China are arguably more vulnerable, but the probability of a US recession is likely to continue to be the market's key focus.

Tactical caution but Retaining a Positive 12-month Outlook

Corrections are an uncomfortable but common part of equity investing. It would be great to predict every correction and bear market, but that is extremely difficult. For most long-term investors volatility is best dealt with via a well-diversified multi-asset portfolio. Big bears and more mild and shorter ~20% corrections are roughly equally as likely based on history. Genuine bear markets are ideally worth taking some extra insulation against, particularly if they prove to be drawn out affairs. We will continue to watch the path of US inflation and leading indicators of increasing US recession risk closely.

At present, a correction rather than a genuine bear market is our central case, although we continue to have some caution around the short-term path of the US market. The US market may reach the -20% bear market correction marker in coming weeks; however, this marker does not in itself tell us much at all about market prospects over the coming year or so. The key is likely to be the path of US inflation and the path of the US economy over the next 12-18 months.

Australia is a lot further away from a bear market correction and should continue to demonstrate some relative resilience, but a US recession or a soft landing will likely determine how Australia performs over the coming year, even if the local economy itself avoids recession.

We remain tactically cautious but have not moved to an outright bearish stance on risk assets. Our base case is for improved performance over the coming year as inflation cools and the US and local economies slow but continue to expand.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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