GUGGENHEIM

Summer 2018

Crucial Conversations
Putting Pullbacks in Perspective

Pullbacks & Bouncebacks

"Market pullbacks can be unnerving. That is why investors should make a plan with their financial advisors that addresses pullbacks and is informed by historical perspective, not emotion."

We can gain important perspective on market pullbacks by considering post-World War II declines in the S&P 500® Index. The majority of declines fall within the 5-10 percent range with an average recovery time of approximately one month, while declines between 10-20 percent have an average recovery period of approximately three months. Pullbacks within these ranges are not uncommon, occurring frequently during the normal market cycle. While they can be emotionally unnerving, they will not generally undermine a well-diversified portfolio and are not necessarily signals for panic. Even more severe pullbacks of 20-40 percent registered an average recovery period of only 15 months.

The Deeper the Stock Market Decline, the Longer the Recovery[1]
Declines in the S&P 500® (Since 12.31.1945)

Decline %	Number of Declines	Average Decline %	Average Length of Decline in Months	Average Time to Recover in Months
5-10	78	(6)	1	1
10-20	27	(13)	4	3
20-40	8	(27)	11	15
40+	3	(51)	22	58

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In contrast, pullbacks of 40 percent or more, while occurring much less frequently, post an average recovery time of 58 months and can potentially compromise an investor's financial plan. Pullbacks above 20 percent (including all pullbacks above 40 percent), that have registered the longest recovery periods have been associated with economic recessions. When evaluating a market pullback, the probability of a recession is a key insight to consider when determining whether or not to reduce equity exposure.

While recessions are readily identifiable in hindsight, prospectively they can be difficult to spot. This makes access to reliable market analysis all the more important when determining the probability of a recession.

Where Are We Now?

(Guggenheim Investments provides its view of the current market environment (as of 8.2018))

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The U.S. economy had a stellar second quarter, with real GDP growth accelerating to 4.1 percent annualized. As we expected, fiscal easing is boosting growth further above potential, which we estimate to be just 1.5 percent. While growth should moderate in the third quarter, government spending will support the economy in the quarters ahead. Nevertheless, our research still indicates that a recession is likely to begin around early 2020.

With growth above potential, the labor market is on track to overheat. Trend payroll growth remains roughly two times its sustainable rate, consumer and business surveys point to increasingly tight labor conditions, and job openings exceed the number of unemployed workers to fill them. This has driven an acceleration in wage growth, with private-sector employee compensation costs rising 2.9 percent in the second quarter of 2018, up from an average of 2.0 percent from 2012–2015.

Inflation stands at the Fed's target, with core personal consumption expenditures (PCE) running at 1.9 percent year over year. Given the 18-month lag between GDP growth and core inflation, strong growth should nudge up inflation through 2019, particularly given recently enacted import tariffs. Given the U.S. administration's threats of much broader tariffs, near-term inflation risks are skewed to the upside. We have long argued that the Fed's policy stance will turn restrictive in 2019 in order to slow economic growth and job creation to more sustainable rates. Fed policymakers now agree, with nearly all Federal Open Market Committee (FOMC) members projecting in June that rates at end-2019 will be above their respective estimates of neutral. On average, policymakers expect rates to be 0.5 percent above neutral by end-2020. The market either believes that the neutral rate is lower or it is skeptical that the Fed will get restrictive, with just three hikes priced in for the rest of the hiking cycle. We expect six hikes, like the Fed, but we see them all happening before the end of 2019. Restrictive Fed policy is coming.

With economic growth unsustainably high, the labor market tight, and Fed policy heading into restrictive territory, it is natural for the Treasury yield curve to flatten. We believe we will see further bear flattening toward our 3.5 percent terminal fed funds rate projection over the next year, implying a roughly 50 basis point increase in 10-year yields from here. Equities and credit risk assets should perform well in the short-term, but over a longer horizon we see an unfavorable risk/reward tradeoff given escalating trade tensions, geopolitical risk, and a recession approaching in 2020.

Guggenheim's Recession Dashboard and Recession Probability Model Point to the Next Recession in the First Half of 2020

"Taken together, our Recession Dashboard and our proprietary Recession Probability Model, point to the next recession beginning in late 2019 to mid-2020."

The business cycle is one of the most important drivers of investment performance. It is therefore critical for investors to have a well-informed view on the business cycle so portfolio allocations can be adjusted accordingly. At this stage, with the current U.S. expansion showing signs of aging, our focus is on projecting the timing of the next downturn.

Guggenheim has developed several tools to guide this effort. The last several expansions have shown similar patterns leading up to a recession. We have created a Recession Dashboard of six indicators that have exhibited consistent cyclical

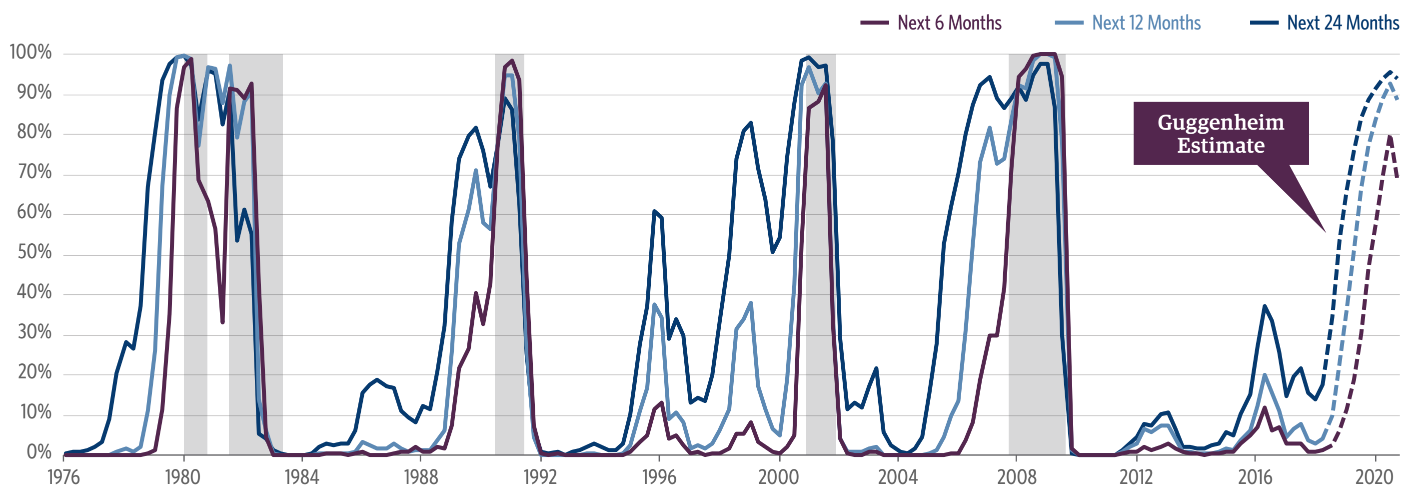
behavior, and that can be tracked relatively well in real time. These six indicators include a measure of the unemployment gap, the stance of monetary policy, the shape of the yield curve, the Leading Economic Index, changes in aggregate weekly hours worked, and changes in consumer spending. In addition to our dashboard of recession indicators, we have also developed an integrated Recession Probability Model that attempts to predict the probability of a recession over six-, 12-, and 24-month horizons. Our methodology is explained in greater detail on our *Forecasting the Next Recession* page on www.guggenheiminvestments.com.[1]

Taken together, our Recession Dashboard and our proprietary Recession Probability Model, point to the next recession beginning in late 2019 to mid-2020. Recent developments in fiscal policy, the labor market, and the neutral interest rate suggest that the expansion could extend into the latter half of our recession range.

Naturally, there are substantial risks that our recession date could be too early or too late. Nevertheless, we believe that successful investing requires a roadmap, as with any other endeavor. Our investment team uses this roadmap to help guide our portfolio management decisions, in order to seek superior risk-adjusted performance over time and across cycles.

Near Term Recession Risk Has Fallen, But Expected to Rise

Model-Based Recession Probability



Hypothetical Illustration. The Recession Probability Model is a new model with no prior history of forecasting recessions. Its future accuracy cannot be guaranteed. Actual results may vary significantly from the results shown. This illustration is not representative of any Guggenheim Investments product. Source: Haver Analytics, Bloomberg, Guggenheim Investments. Data as of 6.30.2018. Shaded areas represent periods of recession.

Interval Since Last Non-Recessionary Pullback

While there is a relationship between the days since the end of the last correction and the magnitude of pullback, as shown in the following chart, the majority of pullbacks during non-recessionary periods registered declines under 20 percent. As we discussed earlier, pullbacks falling within the 5–20 percent range historically experience recovery periods of one to four months. These are not periods typically associated with severe economic deterioration, and do not necessarily represent a signal to reduce equity exposure. As of the date of this analysis (8.3.2018), there had been 176 days since a non-recessionary market pullback of greater than 10 percent.

1. Visit page at https://www.guggenheiminvestments.com/perspectives/macroeconomic-research/forecasting-the-next-recession.

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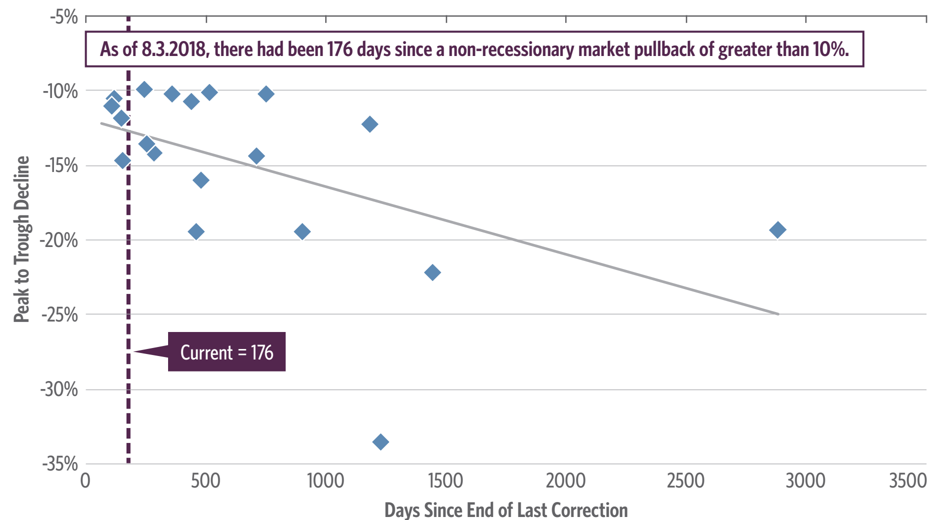
Ex Recession S&P 500 Corrections (>10% Decline)[1]

Since 1962



[1]Source: Guggenheim Investments. Data as of 8.3.2018.

Putting Pullbacks in Perspective

"It's important to put market pullbacks in context to determine what they mean. Working with your financial advisor, you may then better assess any potential impact on your portfolio and implement a proper course of action."

Pullbacks are often not a time to panic and should rather be used as a reason to analyze and assess. Under certain circumstances, it may even be the case that a pullback represents an attractive buying opportunity for certain portfolios. The benefit of gaining reliable market and economic perspective is essential in preparing for market pullbacks. Rather than act on emotion, it's important to put these events in context to determine what they mean.

Working with your financial advisor, you may then better assess any potential impact on your portfolio and implement a proper course of action, if any is necessary, that is in line with your investment objectives.

To learn more, speak to your financial advisor about Guggenheim Investments' timely insights and thought leadership.

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