

Equity selloff: Something other than “something worse”



January 24, 2022

Global Portfolio Advisory Committee

With the economy downshifting to a more sedate pace of expansion and ongoing inflation risks, it's no surprise markets are on edge. But in the absence of convincing signals that a recession is in the offing, we regard the pullback as something that should be endured on the way to further market gains instead of “something worse.”

After the U.S. equity market delivered its strongest and longest post-trough rally since at least the 1960s, with the S&P 500 Index surging 114 percent from March 2020 through early January 2022, several factors have come together to push the broad averages lower over the past three weeks, raising the prospect that equity markets may be undergoing the first meaningful correction since this bull market got underway 18 months ago.

The S&P 500 gained much more in the upswing than other developed markets and became decidedly more richly valued on a price-to-earnings basis in the process. It's perhaps not surprising then that it has suffered more in the pullback to date.

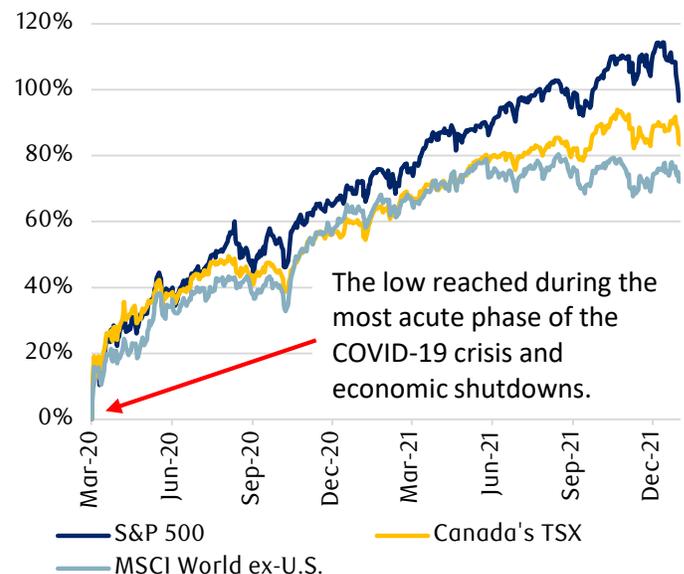
The S&P 500 has retreated 8.1 percent since its early January peak; Canada's S&P/TSX Composite Index has declined 3.1 percent and the MSCI World ex-U.S. Index is down 4.5 percent during the same period. The weakest link has been growth stocks, a market segment that includes the Technology sector and represents a large slice of the U.S. market—thus its underperformance. The S&P 500 Growth Index and the Technology sector have fallen 12.1 percent and 12.0 percent, respectively, since the market's January peak.

Equity markets are mainly adjusting to:

- Ongoing global inflation risks and statements by major central banks that they could tighten monetary policies more aggressively than previously indicated;
- The related upward move in sovereign bond yields;
- Signals from U.S. and multinational companies that inflation is posing greater challenges for expense

The S&P 500 has pulled back after a historic rally

Performance since the COVID-19 low in March 2020 (%)



Even including the recent pullback, the S&P 500 is still up 97% since the market low reached on March 23, 2020.

Source - RBC Wealth Management, Bloomberg; data range 3/23/20–1/24/22

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management and profit margins, as more management teams are citing wage pressures during the current earnings reporting season;

- Potential knock-on effects of tighter central bank policies for economic and earnings growth; and
- Indications that omicron is temporarily constraining economic activity and slowing the process of supply chains and employment getting back to normal.

Geopolitical risks are likely affecting market sentiment as well, particularly heightened tensions between the U.S./NATO and Russia—the most acute in the 30-year post-Soviet era—and the related eight-year internal Ukrainian conflict between Kiev and the separatist area of eastern Ukraine. While these risks are not being widely cited by North American market participants as major factors in driving down equity prices, energy commodity strategists point out the disputes have pushed crude oil and European natural gas prices higher. Should geopolitical risks escalate further, they could become more prominent for financial markets.

Transition struggle

When uncertainties about economic and earnings growth arise, it naturally provokes a debate and worries about whether “something worse” is happening that might put the expansion and bull market at risk.

The economies of most developed nations have been in “recovery” mode for a number of quarters—a stronger-than-usual recovery at that. Economic activity rapidly accelerated as pent-up demand, restocking, easy credit conditions, and employment roared back to life following the most acute phase of the COVID-19 pandemic. Corporate profits and stock prices followed the same path, rebounding energetically. Recovery periods usually feature the fastest GDP and earnings growth rates of the cycle.

Now the economy and markets are shifting gears. The “roaring” cycle is giving way to a more sedate pace of economic expansion with all of the worries that typically come along with it, including some that markets have not faced for decades, such as high inflation. The transition from “fast” to “more normal” economic growth usually provokes some soul-searching by market participants. That discussion is often accompanied by volatility in

equity markets—which is what we think is playing out right now.

Some market participants are concerned about central banks being behind the curve, others are concerned they could over-tighten by hiking rates too much. We can’t remember a Fed rate hike cycle where market participants didn’t express worries about these opposing scenarios—this is par for the course. And these concerns typically occur surrounding each and every Fed tightening cycle despite the fact that the U.S. equity market has historically performed well in the 12 months that precede the first Fed rate hike and have typically delivered positive gains in the 12 months following the initial hike.

The expansion is intact, as is the outlook for equities

In the absence of convincing signals from the economy and credit markets that a recession is in the offing, we regard an equity correction as something that should be endured on the way to further worthwhile market gains as the economic expansion plays out this year and likely next year, if not longer.

At this stage, [all seven of our U.S. leading economic indicators of recession](#) are giving readings consistent with the economic expansion having further to run despite the inflation headwinds and uncertainties surrounding central bank policies. We think a prolonged period of monetary tightening—beyond what is currently being contemplated by the Fed and other major central banks—would be required to move the recession indicators into the hazard zone.

When the U.S. economy is devoid of major recession risks, bull markets typically endure, although they often include bumpy periods and normal corrections. When recession risks increase meaningfully is when bull markets tend to get into real trouble.

While the current risks facing markets have the potential to generate further volatility or downside, we don’t think the economic backdrop has deteriorated in such a way that investors should reposition broad asset class exposure in portfolios. We remain moderately overweight global equities with the view that major developed equity markets have the potential to deliver worthwhile gains for the year and probably beyond.

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