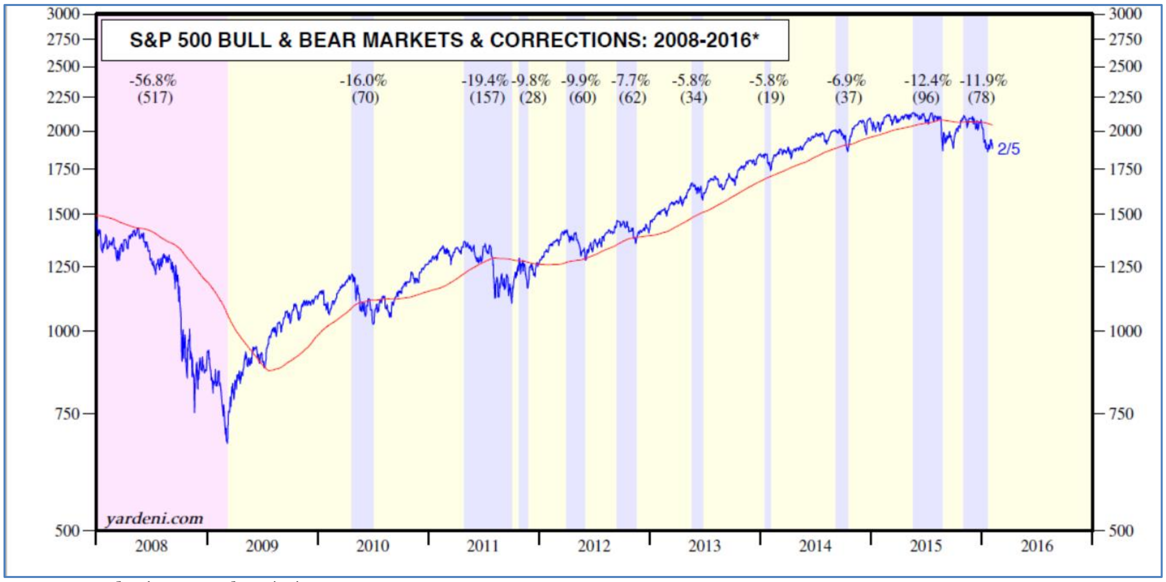
Bull Markets Do Not Move in a Straight Line

The financial markets have started the year on a rocky path. Investors are contending with persistent headwinds, ranging from continued weakness in oil prices to concerns about the impact of China's slowing growth on the global economy. While these concerns are legitimate, some positives remain on which optimists can hang their hats. As we noted in our 2016 Market Outlook, we do not have a super bullish take towards the equity markets. Instead, in our view the financial markets should see a solid footing though increased volatility is the most likely outcome.

Two primary factors weighing on equities so far this year are Chinese stock market volatility and weakness in crude oil prices. With respect to China, recent weak economic growth data has worried investors about that country's economic strength. Regarding low oil prices, an economic slowdown in China would likely affect its demand for energy while continued production increases from OPEC members is further exacerbating the price drop. Investors are concerned that continued declines in crude oil prices may have more negative consequences to the global economy. The energy industry is not a stand-alone business, so a decline in oil prices does not just hurt energy companies—it may also have a negative impact on capital and infrastructure investment. Industries that directly and indirectly support energy companies, such as insurance, lending, and equipment manufacturers, may decline as well. As result, low oil prices could hurt overall corporate earnings, create layoffs, and reduce future capital expenditures. Since energy companies tend to be large, publicly-traded entities, it is not surprising that this sector has been the worst performing part of the S&P 500 over the past year.

While investors have focused on the negative news, it is important to keep in mind that there are still market positives that may support optimism. We remain in a historically low interest rate environment while global monetary policy is still accommodative. The recent market volatility and related weakness in some economic data is making the Fed less likely to raise rates in the near-term. According to the CME Group, there is a 98.1 percent chance the Fed will not raise rates at its next meeting, and expectations are pointing to fewer rate hikes overall. This environment continues to offer significant benefits for borrowers and potentially provides a support level to equities worldwide. Outside of low interest rates, other positives include solid gains in the housing and labor markets, which further indicate that the current economic expansion remains intact. Inflation remains well under control. Lastly, recent market weakness has resulted in better market valuations. While there are market positives, it is sometimes easier to focus on the negatives during market retreats.

Bull markets do not move in a straight line, so the recent volatility and market weakness should not be surprising to investors. However, what has scared investors today is its duration. As noted by Yardeni Research, the current selloff is the longest since the bull market began. They note that the S&P 500 is only down 11.9 percent from its record high on May 21, 2015 (through February 5, 2015), which is basically an average correction. However, the following chart shows it has lasted 260 days so far (with a breather in between), for the longest correction since the bull market began in 2009.



Source: Yardeni Research, 2/8/2016
*Corrections (declines of more than 10%) are shown in blue. Number of calendar days are listed in parentheses.

Though we highlight the current market positives, we are not eschewing investor concerns. The financial and economic impact of a weaker Chinese economy and the signal that lower oil prices are providing are definitely real. Instead, we would focus on what to do going forward to brace against elevated levels of market volatility. The equity market is undergoing a phase where it is evaluating fundamentals relative to valuation. Where that tradeoff winds up is difficult to determine as investor emotion can skew the results. Keep in mind that the current selloff is still in line with most bull market corrections. The primary difference this time is that it is more prolonged than past ones. While we are not screaming bulls at current market levels, we are instead watching fundamental and technical indicators for more information about market direction and investor emotion. For example, the next possible technical support level for the S&P 500 is between 1,812 to 1,820, representing the 2016 low (1,812) and the October 2014 low (1,820). As of the publication of this commentary, the current level on the S&P 500 is 1,835. While support levels are sometimes breached, we believe 1,800 on the S&P 500 is the more important psychological level for investors. If the index significantly breached these levels, we would reevaluate market and technical data.

While we do believe that interest rates will likely stay “lower for longer,” we would not aggressively purchase bonds as a safe haven against market volatility. In an attempt to avoid the stock market selloff, investors have flocked to the perceived haven of long-term U.S. government bonds, which have seen a dramatic price jump, but this has sent Treasury yields, which move in the opposite direction, down to levels last seen in February of 2015 toward the low end of our expected range. With upside limited, we would target other ways to reduce portfolio volatility.

Instead, it is more important to focus on the longer-term and brace yourself for short-term market fluctuations. With that in mind, we continue to suggest being more diversified than normal in your portfolios, incorporate alternative investments that have historically shown to offer protection in poor markets, and keep in constant contact with your financial advisor. Your experienced financial advisor has seen similar market pullbacks and is prepared to help you navigate this current market pullback.

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