THE DRIVE YOU DEMAND

FIVE TRIGGERS FOR A MARKET BOTTOM

Spotlight

Global Investment Committee

UNION BANCAIRE PRIVÉE

Key points

- *Historically, US bear markets are rare outside of a US recession. However, a turn in markets will likely require some mix of the following:*
- *Investors should watch for a shift to tightening financial conditions to signal a change in Fed tone to ease some of the pressure on markets.*
- *Valuations in the S&P 500 have only fallen below 15x forward earnings in the context of a recession or global crisis since 1990. At 15.7x earnings, a 5–6% fall in P/Es would signal overpricing of recession risk.*
- *To mitigate the prospect of a eurozone crisis, pressure to resolve the Italy–EU budgetary conflict would increase should Italian yields move to challenge 4%.*
- *Turning to China, signs of proactive rather than reactive policy stimulus would calm fears of a tariff-driven slowdown in Chinese growth.*
- *Strategically, hedge funds and capital-protected equity exposure remains valuable in the face of asymmetric risks facing investors in 2019.*

Having spent much of the past six weeks on the road meeting clients in Europe, Asia and the Middle East and travelling in North America, we notice the pivot in sentiment from the optimism of September to the anxiety of October has been dramatic.

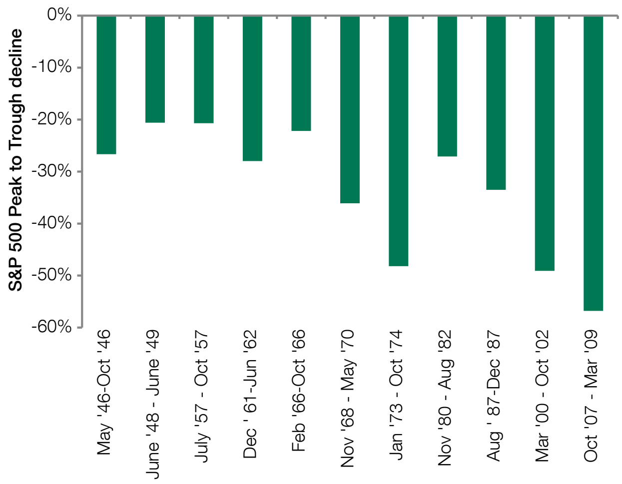
Our recent publication, *P/E De-Rating in Progress* (October 2018), set out to address the most common questions about why the recent sell-off has taken place. Given the persistence of the declines, many clients are now asking:

1) "Are we in a new bear market?"
2) "If not, "when will this sell-off end?"

Are we on the cusp of a new bear market? Not yet.

Looking back to the end of World War II, the US market has experienced 11 bear markets (declines of <20% peak to trough). Seven of the eleven bear markets observed have occurred in the context of a US recession. UBP's Recession Watch framework identifies few recessionary signs across manufacturing, consumption or credit conditions. Instead, as highlighted in our May 2018 report, *Navigating the coming 'Mini-Cycle' in the US Economy*, economic data, earnings and market dynamics all appear consistent with a mini-cycle in the US economy – characterised by a decelerating manufacturing sector but with firm consumer/employment markets – rather than marking the approach of an economic recession.

US Bear Markets since World War II



Sources: Standard & Poor's, Bloomberg Finance L.P. and UBP

Admittedly, however, the S&P 500 has seen four bear markets outside of a recession, though only one of those having occurred after 1970 – the stock market crash of 1987.

Interestingly, despite limited data, anecdotal descriptions provided by the Federal Reserve Bank of Richmond suggest that these pre-1970 bear markets were in the context of mini-cycles not supported by countercyclical Fed policy.

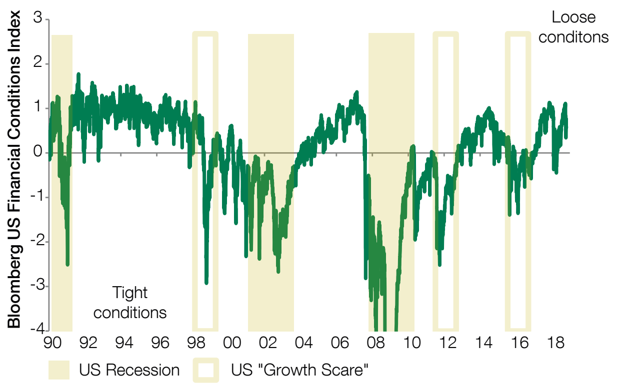
So with US markets sitting 8% lower than their 2018 highs, history suggests that a passive Federal Reserve in the face of sharply declining markets is a necessary condition for a bear market outside of an economic recession.

Five potential triggers for a market bottom

As noted earlier, those bear markets which have occurred outside of a recession have tended to emerge against the backdrop of a mini-cycle in the US economy (which we believe we are in) *and* in the face of passive Fed policy.

Admittedly, recent communications suggest a hawkish tone that might be construed as passive Fed policy in the context of such recent, sharp market declines. However, set against the broader financial backdrop in the US economy, even with the October declines in markets, US financial conditions remain loose in a historical context. They are only moderately below the peaks seen in the economic expansion of the mid-1990s and mid-2000s (see chart).

Watch US financial conditions to signal more 'dovish' Fed communications



Sources: Bloomberg Finance L.P. and UBP

TRIGGER 1 – FED TONE TO NEUTRAL. Thus, the first trigger, we suspect to lay the ground work for a more durable bottom in markets are neutral to tight financial conditions which prompt Fed communications to shift from the 'hawkish' stance they've turned to in recent months to at least neutral.

As noted in our early-October report, *P/E De-rating in Progress*, 2018 has seen S&P 500 P/E multiples decline persistently. Indeed, with forward P/Es for the US benchmark reaching close to 20x earnings at their peak in January 2018, valuations began the year at near 30-year highs excluding the Technology Bubble of 1999–2000.

With the declines of October, the S&P 500 currently trades at 15.7x forward earnings. Deep US recessions, such as 1990–91 or 2008–09 or global crises, like 1994–95 in Mexico and 2011–12 in Europe, have seen forward P/E multiples compress to below 15 times forward earnings, reaching as low at 10–11x forward earnings at their trough.

However, investors will remember that in early 2016, the US economy experienced a growth scare as energy companies triggered concerns about defaults in a key sector important for US capital spending and economic recovery since 2008. Similarly, coming out of the tech bubble which drove a US capital spending boom and economic growth in the late 1990s, the ensuing bust spurred only a mild US recession.

TRIGGER 2 - VALUATIONS. In both situations, S&P 500 P/Es bottomed near 15x earnings, approximately 5–6% below their current levels. So, in the absence of any developing signs of an economic recession, declines to much below 15x earnings in the S&P 500 should begin to tilt risk–reward in favour of investors.

Look for S&P 500 fwd P/Es to price recession risks

Sources: Factset and UBP

Should valuations and the tone of Fed communications shift in favour of investors in the weeks ahead, any capitulation in the markets should likewise provide a signal for investors of a more durable bottom in markets.

With the CBOE SPX Volatility Index (VIX), a market 'fear gauge' at 24, it is well above the 11–12 levels seen as recently as September. However, it has yet to spike above the 30 level that marked lows in the S&P 500 in early 2016 (during the US growth scare) as well as in early 2018.

Admittedly, in 2010–12, as the eurozone Sovereign Crisis developed, the VIX Index spiked well through the 30 level to as high as 45 before triggering the bottom (coinciding with an easing of policy from the Federal Reserve and ECB).

TRIGGER 3 – EXCESSIVE FEAR. Therefore, without evidence of a systemic crisis, a spike in the market's 'fear gauge' to above 30 could provide signals of a market bottom.

Real concerns about a hawkish Fed in 2019 have clearly contributed to the weakness in October while rising geopolitical worries have likewise weighed on markets.

As a result, signs of stability on key geopolitical axes would undoubtedly be helpful at removing the prospect of a non-domestic crisis (like Mexico in 1994–95 and the eurozone in 2010–12) from triggering a further de-rating in the S&P 500.

In particular, the slowdown in the Chinese economy, continued weakening of its currency, combined with further tariff rises scheduled for January 2019 on exports to the US raise fears of a disorderly unwinding of the high leverage within China's economy.

TRIGGER 4 – PRO-CYCLICAL POLICY ACTION FROM CHINA. Though Chinese policymakers have reluctantly eased policy to support its slowing economy, a more proactive easing of domestic policy, probably via further cuts in domestic reserve requirements, would move to calm fears of a more dramatic slowing in Chinese demand that might weaken already frail emerging economies.

With 4th quarter GDP growth expected to show continued slowing towards the critical 6% level and with the next round of tariffs on Chinese exports to the US set to be implemented in the new year, pressure should build on China to pivot towards a more pre-emptive policy agenda to stabilise and accelerate growth in early 2019.

On the continent, the confrontation between Italy and the European Union has weighed on Italian assets, but has not yet resulted in broader contagion across the euro area.

However, we still see little political motivation for either the Italian coalition government or the EU to compromise on their positions so early in the budget negotiations.

TRIGGER 5 – ITALIAN YIELDS APPROACHING 4%. The combination of Italian 10-year yields at 3.6% and the end of ECB net bond purchases in the new year should increase pressure meaningfully towards a negotiated solution, especially should yields rise towards the critical 4% level that may trigger capital concerns among Italian banks.

On balance, fundamental (Fed policy and valuations), technical (excessive fear), and geopolitical (China and Italy concerns) suggest that the headwinds that have corrected elevated valuations remain substantially in place. As they ease, tactical opportunities may present themselves. However, strategically, we continue to believe that hedge funds and capital-protected equity exposure remains in the face of building risks in 2019.

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