Market Decline Intensifies as Fear Replaces Complacency: Stay the Course

Equity markets experienced huge selling pressure in October as the S&P 500 is down 5.0% the past two days and -6.1% in October. The technology-heavy Nasdaq Composite index is down 8.9% in October and is now off 9.6% since setting a new high on 8/29/18. The decline has been led by weakness in the Technology and Consumer Discretionary sectors, by far the best performing sectors in 2018 through the end of Q3, as well as Communication Services. All sectors are down from levels at the end of September. We attribute the market weakness to the recent rapid increase in U.S. interest rates, which could disrupt GDP growth in 2019, as well as fears that Q3 corporate earnings reports and outlooks (beginning in earnest next week) will reflect caution related to weakening global demand and a strong U.S. dollar. We see the potential for additional weakness in the short-term as investors react to uncertainty and technical traders add to the selling pressure. Our view is that Q3 earnings growth is likely to exceed expectations, which could lead to higher equity prices by year-end. After several quarters of underperformance for value sectors relative to growth, we believe that value could begin a period of stronger relative performance going forward. This would include stocks in the Financials, Healthcare and Energy sectors.

Our S&P 500 target remains 2,975, which is now 9% above current levels. We expect an increase in volatility as mid-year complacency and low volatility has ended while investors navigate a rapid increase in interest rates and uncertainty regarding the sustainability of above-trend corporate earnings growth. We see the potential for lower market P/E ratios in an environment of rising interest rates but point out that the S&P 500 P/E multiple on forward earnings expectation is now well below levels seen early in 2018. We believe that equity market returns will remain positive, and will roughly keep pace with estimated earnings growth of 10% in both 2019 and 2020. To address sector swings that often come with increasing volatility investors should review sector and asset allocation and maintain diversified portfolios

Our 2,975 S&P 500 price target represents a P/E of 17.2x current next 12-month (NTM) FactSet consensus index EPS estimate of $172.75. The index currently trades at 15.8x that estimate, which is in-line with the market's average forward P/E multiple of 15.7x (in a range of 10x to 27x) since 2000.

For the full-year 2018, S&P 500 EPS are estimated to grow 21.9%, and this follows 11.3% EPS growth in 2017. FactSet consensus S&P 500 EPS estimates for 2019 and 2020 reflect growth of 10% for both years. While we do not view U.S. 10-year Treasury yields of 3.20% as a headwind for equities, we do believe that P/E multiples will come down as rates rise and that market gains will become increasingly linked to ongoing earnings growth.

Second quarter U.S. GDP increased 4.2%, up from 2.2% in Q1, and reflected the strongest quarterly growth since the third quarter of 2014. Consumer spending and a resurgence in business investment have driven GDP strength in recent quarters, including Q2. The FactSet consensus 3Q18 GDP growth estimate is 3.2% and has moved steadily higher from a 2.7% estimate at the end of July. The Atlanta Fed GDPNow estimate, which adjusts as data is reported throughout the quarter, estimates 3Q18 GDP growth of 4.2% as of 10/10/18.

U.S. consumer confidence, small business optimism, manufacturing purchasing managers surveys (PMI), and services PMIs have remained at cycle highs in 2018. In addition, the U.S. employment outlook is healthy with multi-decade low unemployment rate of 3.7% in September. We look for continued above-trend growth in GDP in 2018 and 2019, but the strong trajectory creates potential headwinds for U.S. companies and equity market upside. The U.S. housing market has stalled as housing starts, new home sales, and existing home sales have been lower than expected, despite population and household formation data suggesting that housing supply remains well-below long-term needs. Automobile sales in 2018 have trended below 2017 levels. Despite these negative trends in housing and autos, we expect ongoing healthy consumer spending driven by employment and wage gains, although we will be watching the data closely. We see additional headwinds from a more uncertain global growth outlook as GDP growth in China, most of Europe, and emerging markets has trended below expectations.

We attribute strong 2018 market returns to growth stocks in the Technology and Consumer Discretionary sectors. The S&P 500 Technology sector, comprising about 26% of the index capitalization in September, contributed approximately 56% of the index price gain YTD through September. Consumer Discretionary, comprising about 13% of the index weighting, contributed nearly 28% of the market gains. Combined, Technology and Consumer Discretionary were responsible for 84% of the S&P 500 YTD gains. In our view investors should look to diversify portfolios and remain diversified across sectors focusing on quality companies, strong balance sheets and positive cash flows.

James D. Ragan, CFA
Director of WM Research
(206) 389-8000
dadavidson.com