Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

3 Reasons for the Market Selloff

By Mitch Zacks
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The S&P 500 has officially crossed over into correction territory[1], which is generally defined as a decline of -10% to -20% over a reasonably short period of time (few weeks to a few months). As I wrote last week, little has changed fundamentally over the past two weeks with regard to interest rate expectations, earnings expectations and the potential length of a trade war with China – yet the market is acting like all three of those factors turned sharply negative overnight. They didn't, in my view.

In this week's column, I take a look at some of the most commonly cited equity market concerns, debunking them one at a time.

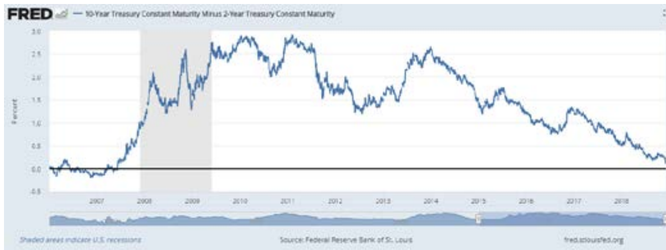
1) **Yield Curve Inversion Sparks Fears of Imminent Recession –** the brass tacks on this investor concern is that it stems from a valid historical fact: *the yield curve has inverted prior to each U.S. recession over the past 50 years*.

The thinking follows that an inversion today can only mean one thing: a recession (and bear market) is next. But I believe there are problems with jumping to such a conclusion so quickly. The first is that the period of time between a yield curve inversion and a subsequent recession has typically been fairly significant – 14 to 34 months. But perhaps more importantly, stocks have historically gone up +15-16% *on average* in the 18 months following a yield curve inversion, underscoring the fallacy of using a yield curve inversion alone as a rationale for going defensive.

Second, it is critical to note that past recessions saw inverted yield curves *accompanied* by a variety of other negative economic signals, from layoffs to contracting PMIs to credit deterioration. History shows that recessions have not occurred without such negative accompaniments.[2]

Lastly, and perhaps most importantly, the yield curve has not even inverted yet! For all the talk of yield curve inversion, I believe it is premature – the 10-year U.S. Treasury is still higher than the 2-year, as you can see from the chart below.

10-Year U.S. Treasury Minus the 2-Year U.S. Treasury



Source: Federal Reserve Bank of St. Louis

2) **Economic Peak Concerns --** the U.S. economy added 155,000 jobs in November, which fell below expectations, and the unemployment rate remained at 3.7%.[3] Softer jobs reports, coupled with the growing sense that the impact of tax cuts on corporate earnings has almost fully run its course, has many investors convinced that U.S. economic activity may have peaked. I actually agree with this sentiment, but with one clear difference: peaking does not necessarily mean turning negative. Earnings expectations are almost certain to continue moving lower in the coming quarters, which I believe could limit return expectations in the coming year. But investors should not throw the towel in on the economic expansion just because it may be peaking – in my view, it's actually a clear signal that there is more runway left, and more time to make those types of decisions.

3) **China, Trade, the Fed, etc. –** these are what I like to refer to as "recycled fears," or the ones you'll most commonly hear about in the day-to-day financial news cycle. The more you see these stories dominate the headlines, the less pricing power they actually have, in my view. Fears over trade and the Federal Reserve raising interest rates too quickly have been around all year, and we believe that they are likely fully priced into stock prices already. If anything, I believe the dominance of these stories in the headlines actually leaves room for positive surprises in the coming months and quarters, when the fears fade and do not have as bad an economic impact as originally feared.

Bottom Line for Investors

As I wrote last week, I believe it is imperative for investors to remember that you should make investment decisions based on changing fundamentals – *not on changing prices.* For now, we believe the economic fundamentals remain intact, and we'd urge patience.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Google Finance, December 11, 2018
[2] Credit Suisse, U.S. Equity Strategy. December 6, 2018.
[3] Charles Schwab, December 7, 2018. https://www.schwab.com/resource-center/insights/content/stocks-drop-on-economic-and-trade-concerns

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