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FLASH NOTE

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CHRONICLE OF A CORRECTION FORETOLD

Is anyone surprised? At the close of equity markets on Monday, 5 February, the broad US S&P 500 index had fallen by 7% from its record high on 26 January and indications on Tuesday pointed to further declines. Investors have been anticipating a correction in equity markets for at least a year. Market volatility as measured by the VIX index had been below 11 for most of 2017. The 6% rally in large-cap US equities from the beginning of 2018 had always seemed excessive, particularly as it followed on what had been excellent returns over the preceding 12 months.

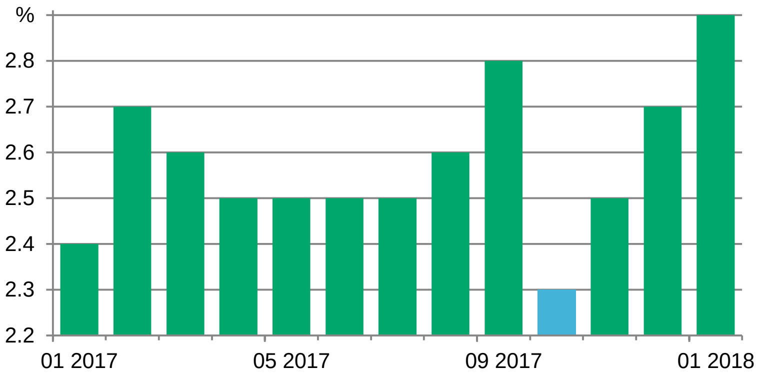
So, why has a correction happened now, and what does it portend? Pressure for a sell-off had clearly been building as 2-year and 10-year US Treasury yields rose from the lows of September 2017 by 90bp and 80bp, respectively, with 2-year yields reaching their highest level since 2008 and 10-year yields their highest since 2014. This increase had been driven by tightening by the US Federal Reserve (Fed) at the short end of the yield curve and the effect of rising inflation expectations on yields at the long end (see Figure 1).

Figure 1: US inflation expectations

Data through 5 February 2018. Note: Five-day moving average of average of 5-year 5-year currency inflation swap rate and break-evens.
Source: Bloomberg, BNP Paribas Asset Management

Although anticipated inflation was rising, it had been difficult to see much evidence of it in the real economy. The change in the US core consumer price index (CPI) was just 1.8% through December, marking the ninth month in a row that inflation had come in below the Fed's target of 2%. Until last Friday, wage growth had also disappointed despite very low unemployment. The trigger for the market correction was the release of US non-farm payroll data that showed better-than-forecast payroll growth and a jump in average hourly earnings to 2.9% year-on-year, overshooting the consensus estimate of just 2.6%. Furthermore, the previous month's figures were revised higher. It seems clearer now that the effects of October's hurricanes on the US economy are fading and the trend in wage growth that existed beforehand is reasserting itself (see Figure 2).

Figure 2: Year-on-year change in average hourly earnings

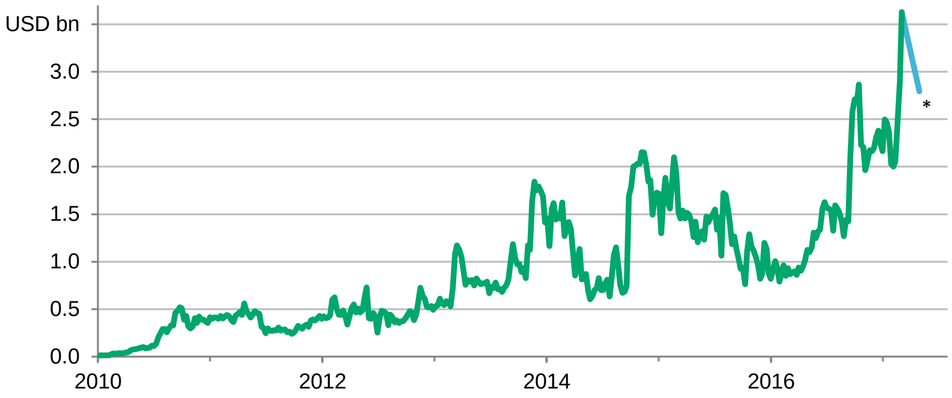


Data through 5 February 2018. Source: Bureau of Labor Statistics, BNP Paribas Asset Management

Market sentiment has swung from previously doubting the ability of the Fed to raise interest rates to wondering whether in fact the Fed has fallen behind the curve, i.e. that inflationary pressures were building and even more interest rates rises than already signalled by the Fed may be in store. Four months ago, the futures market expected the Fed to raise rates just once in 2018; now it foresees three increases (in line with the Fed's own indications).

If the reasons for the market sell-off are clear, the magnitude has likely been exaggerated by technical factors. Long-standing low volatility had encouraged many investors to believe that this calm environment would persist, making an investment in short-volatility exchange-traded notes seem attractive. Loosely speaking, these funds give investors a cash payment at the contract's maturity, with returns based on the inverse performance of the VIX – they make money when volatility falls or remains low. The size of these funds had reached USD 3.6 billion last week (see Figure 3), just before the VIX spiked from 13.5 to a record high of 50. As the index jumped, the funds were forced to buy significant numbers of VIX futures to cover the short positions that had been built up and, in doing so, forced the VIX higher while also locking in losses for the holders of the funds.

Figure 3: Inverse VIX exchange-traded product market value



Data through 5 February 2018. *Note : Trading has been halted. Source: Bloomberg, BNP Paribas Asset Management

More important for the future than such technical factors is the outlook for growth and inflation. The current combination of steady global growth and modest inflation has been termed 'Goldilocks'. Is this still appropriate or do we need to consider a more classic end-of-cycle scenario where economic growth exceeds capacity and inflationary pressures rise, prompting the inevitable action from central banks?

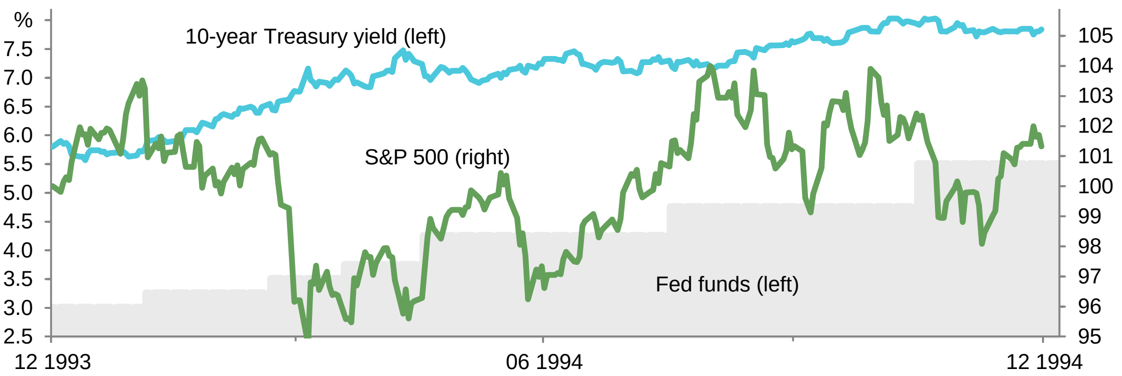
The growth part of Goldilocks remains intact, in our view. Last week's US payroll data showed that the US economy is strong. The eurozone economy expanded at a solid 0.6% in the fourth quarter of 2017. Purchasing manager indices (PMIs) suggest the recovery continues.

The question, of course, is how benign inflation will remain. In the eurozone, there seems little risk of a problematic increase. Core inflation rose from 0.9% to 1.0% year-on-year in December, which is still far below the ECB's target of 2%. Even in the US, the wage data did not present a picture of broad wage gains. It is worth remembering that this is a volatile series, and the number of hours worked declined, boosting the hourly average wage rate. Moreover, if one separates out the wage gains by supervisory workers (17% of the labour force) and those by non-supervisory workers (83%), the picture is mixed. While wages did increase overall by 2.9%, as stated above, this was solely for supervisory workers. The rest of the labour force in fact saw no increase in their rate of wage gains.

We do not anticipate a meaningful acceleration of inflation in America. Given how low it has been, a period of inflation slightly above 2% would be helpful and indeed could be expected given the growth rate of the US economy. Even this small increase in inflation (and hence Treasury yields) is a short-term challenge for equity markets as wages and interest costs rise, crimping profits. But this is unlikely to be enough to diminish the medium-term profit outlook, which remains positive. Interest costs for companies are still extremely low thanks to quantitative easing, so a mild increase should not be problematic. Tax cuts and profit repatriation should help companies reduce debt. Rising wages should support consumption. For the current earnings reporting season, S&P 500 companies have so far shown robust gains of 12.2% in profits and 6% in sales. P/E multiples have declined from a peak of 18.6 times forward earnings just a week ago to 16.9 times currently, by our estimate.

If 1994, when the Fed raised interest rates by 250bp and the 10-year Treasury yield rose by 200bp, is any guide, equities will likely remain weak for a while before recovering (see Figure 4).

Figure 4: US assets in 1994



Data through 5 February 2018. Note: S&P 500: December 1993 = 100. Source: Bloomberg, BNP Paribas Asset Management

How long that period might last will depend on the evolution of inflation. The next data point for investors will be the January US CPI release on 14 February. Expectations are for a slowdown in core CPI from 1.8% to 1.7%, but a negative surprise could prolong the volatility. Nonetheless, to the same degree we believe the growth part of Goldilocks is intact, we also believe that the modest inflation aspect remains in place. Given the Fed's intent to raise policy rates to 2.7% by the end of next year, it is difficult to foresee a dramatic acceleration in inflation. It is certainly too soon to call a bottom to the equity market, but we still believe the environment for risk assets is positive and we expect to be adding to our positions in the near future.

6 February 2018