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RICHARDSON Wealth

Market Ethos

The latest market insights from
Richardson Wealth

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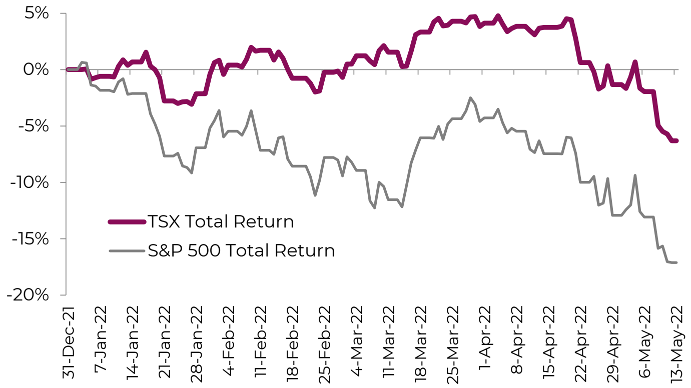
When will it end?

In our travels, two predominant questions we have been hearing from both investors and advisors are: When will this price correction be over, and are we headed towards a recession? In addition to our recent writings and thoughts, here are some thoughts and charts to address those questions.

Correction morphed into indiscriminate selling



When will the correction end?

Perhaps this question is in part jest, as nobody really knows, but we can put things into context. We continue to label this period a corrective phase. Asset prices were goosed higher over the past few years due in part to consumers' shifting behaviour towards more goods purchases, which was better for index earnings. With less to do, individuals saved more, which landed in the markets. Central banks kept rates low and injected liquidity, and governments' fiscal spending boosted economic growth. With those factors now reversing, the somewhat inflated market is deflating. All asset prices were simultaneously lifted higher for many years; just look what a plain vanilla balanced allocation did over the past three years. And now all prices are moving lower in stocks, bonds, and real estate [check out last week's edition for more].

Is there an event or some piece of news that would end the market weakness and trigger a rebound? Perhaps a ceasefire, a lower inflation print, or the central banks backing off. Often at market turning points, a common narrative develops afterwards that points to some event(s) that caused the change in direction. This reassures most to feel there was a cause or event to change the market. But these are really just coincidental. The markets are an aggregation of investor behaviour. The

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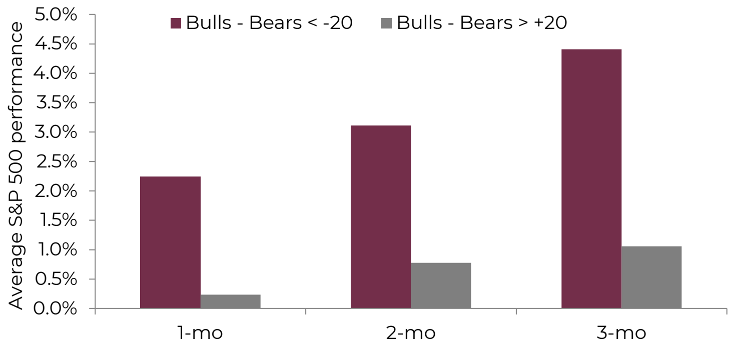
selling pressure will end when a tipping point occurs. Sellers finishing selling, potential sellers deciding current prices are no longer worth selling, and buyers come in attracted by lower prices. This may occur on the day of some macro news, but really it just happens when it happens.

Two positives that this ‘day’ may be upon us are sentiment and valuations.

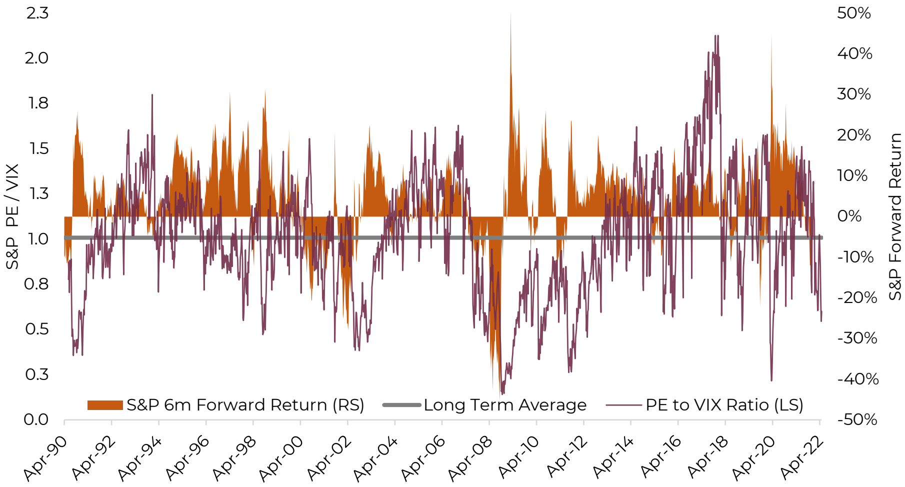
Sentiment – U.S. AAII Investor Survey continues to flag a near-term lopsided bearish tilt. The Bulls minus the Bears are down to -24. Interestingly, the outright bearish sentiment has decreased from a high of 59.4 at the end of April to 49.0. A sentiment indicator such as this one can be rather jumpy, so we use a moving average to help smooth it out. The 4-week moving average of the Bulls minus the Bears is now down to -29.7, well below what historically is considered a good contrarian signal. Looking back to 1987, any time this spread has been below minus 20, the average forward-looking returns over the next few months are very promising. In addition to this survey data, the CNN Fear & Greed Index, a composite of seven fear and greed technical indicators, stands at 12, near the very bottom of the ‘extreme fear’ zone.

S&P 500 Return following sentiment extremes



Value to volatility – Valuations give us insight into prospective returns. Lower valuations typically align with higher expected returns. When combined with elevated levels of market volatility, this creates relative attractiveness for investments. Though uncomfortable, you want to buy when valuations are low, and volatility is high.

Value to Volatility:
Expected returns are highest when valuations are cheap and uncertainty is high. That is NOW



Source: Bloomberg, Purpose Investments

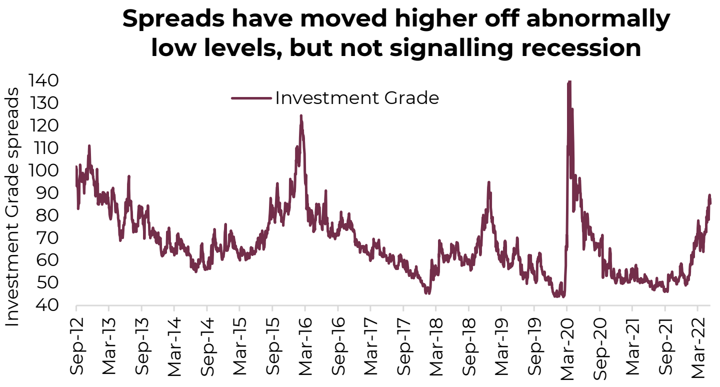
The VIX index, often known as the ‘fear gauge,’ measures implied market volatility based on a set of S&P 500 index options. It’s currently above 30, which is historically high, and market valuations have come down substantially. We can get a sense of whether market fundamentals and investor sentiment are “in sync” by looking at traders’ volatility expectations combined with the relative “cheapness” of stocks. At current levels, there appears to be a disconnect. The ratio of S&P 500 forward price earnings to the VIX currently stands at 0.54, well below its historical average of around 1. A clear sign that market panic has set in, and valuations have reached a level relative to volatility that can be seen as supportive. Based on average forward six-month returns, it’s an opportunistic time to buy, but emotionally one of the hardest.

The recession question

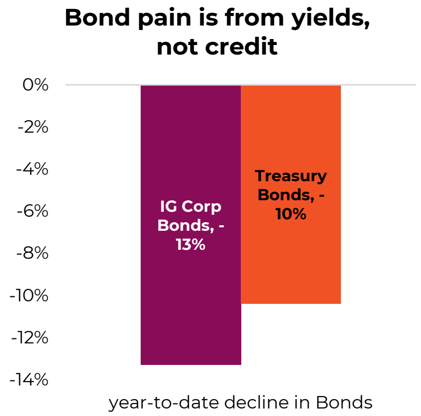
A drop in equity prices that is not accompanied by a near-term recession is always a buying opportunity. A drop in equity prices that is a precursor or warning signal for a recession is not. So, is there a recession coming soon? We do not believe so. As the saying goes, the stock market has predicted nine of the last four recessions.

Admittedly, there have been several recession canaries recently. We have seen the **yield curve**, measured 2 year to 10 year, invert briefly. Noteworthy, but generally very early in its predictive power. **Oil prices** spiking to this degree has foreshadowed economic weakness. **Consumer sentiment** has been weak. We don't discount these signs, but there are also counterpoints: **Supply chain** issues have created backlogs in manufacturing, meaning even if demand slowed, activity would remain for some time to catch up to rebuild inventories. The **U.S. consumer** is in fabulous shape with employment gains, wage gains and lots of pent-up savings. We are not sure why they are so cranky in the survey data; maybe it's the inflation, maybe the war, or maybe the surveys are just unreliable. This unhappy consumer continues to spend like a happy consumer.

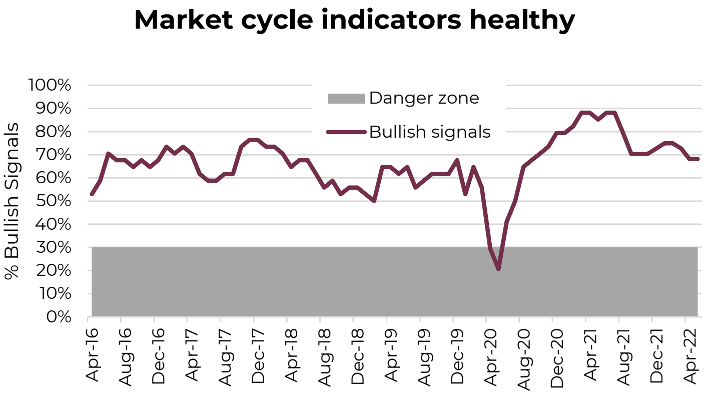
And then there are credit spreads – this is key. Investment-grade bonds (IG) are down about 13% so far this year. However, investment-grade credit spreads – the excess yield priced into corporate bonds over 5-year Treasury bonds - have only risen from about 50bps to 80bps. Similar duration Treasury bonds are down about 10% this year, meaning the majority of the declines are from yields moving higher, not from weaker credit.


Spreads have moved higher off abnormally low levels, but not signalling recession

Source: Bloomberg, Purpose Investments


Bond pain is from yields, not credit

There is a recession somewhere over the horizon, and as this year progresses, the economic data will likely cool. This will make the recession chatter increase, but it is too early to start drawing conclusions or positioning in our view. While it is good to be early, being *too* early is simply being wrong. While there has been some deterioration over the past year, the majority of our market cycle indicators remain positive. Global indicators have softened, but the U.S. – the largest economy – remains strong. And fundamentals, which incorporate valuations and earnings growth, remain encouraging.


Market cycle indicators healthy

Source: Purpose Investments, Bloomberg

Investment implications

This market does have many similarities with the 1994 period of market weakness. Bonds and equities fell together as the market wrestled with fast rate hikes simultaneous with slowing fiscal spending as governments addressed deficits. While there are differences, the market reaction in bonds and equities is similar. It's worth noting that while equally painful for portfolios, it did set the stage for a strong rebound in subsequent months and quarters.

We don't know if the sellers are getting tired or less motivated, or if value investors are starting to step in more aggressively yet. Truthfully, we will only know after the fact. But it does appear things are starting to line up; valuations are attractive, sentiment is flashing 'buy'. Perhaps the price correction has run its course. If you agree that recession risk is low, this is likely a buying opportunity.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist, Purpose Investments Inc. and James Price, SVP Investment Strategies, Richardson Wealth Ltd. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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