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MARKET PERSPECTIVE *from the Investment Advisory Group*

Don’t Lose Sight of the Primary Trend

What Happened?

After one of the sharpest rebounds in history, which saw the S&P 500 rise 60% in less than six months, stocks have weakened over the past month. The S&P 500 is down about 9% since its September 2nd peak, while the tech-heavy Nasdaq Composite has declined more than 11%. The continued selloff on Monday is being attributed to several factors, including weakness in European banks and COVID-19 trends overseas. However, at the center of the decline is a concern that the probability of a fiscal package passing to further support the US economy is waning. The political divide in Washington, which appears to have only grown wider following Supreme Court Justice Ruth Bader Ginsburg’s passing, arguably makes it more challenging for the parties to come together to get a deal completed prior to the election.

Our Take

If a US fiscal stimulus bill is not passed prior to the election, we would view this as negative, but not as fatal, for the overall economy and markets. It could lead to some short-term softness in both. There are, however, some offsets that should help cushion the blow.

The US economy continues to reopen. Confirmed COVID-19 cases have decelerated, as have the number of hospitalizations and death rate (see Truist COVID 19-Economic Data Tracker). The elevated personal savings rate of almost 18%—which is more than double the five-year average—provides some cushion for consumers. Plus, unlike when the first stimulus was enacted during the heart of the pandemic, employment trends are improving, and wages are rising. Moreover, housing is on solid footing, with a homebuilder traffic survey of prospective buyers reaching the highest level in 30 years last week. The economic recovery will likely remain uneven with fits and starts, but the trajectory should remain positive. This is important insofar as our work suggests we are in the early part of an economic expansion. Since WWII, US expansions have lasted more than five years on average, and stocks have risen 85% of the time on a one-year rolling basis during expansionary periods.

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Context to Market Pullback

Even prior to the recent news, our take coming into September was that stocks were extended short term, and rising investor complacency made markets vulnerable to bad news. Indeed, the S&P 500 has tended to see three to four pullbacks of more than 5% during the first nine months of recent bull markets. Prior to the current setback, stocks had only seen two such declines. Moreover, September has often been a more challenging environment for stocks, and volatility tends to rise as the election nears.

Thus, while there is always a reason that causes a pullback, part of the recent setback in our view is simply a normal reset of a market that got ahead of itself. Even strong markets do not move in a straight line. **Our work still suggests this pullback is happening within the confines of a bull market**.

Recall, prior to the September setback, the S&P 500 had risen for five straight months. Since 1950, we have only seen 27 previous five-month winning streaks. **Following 26 of those previous instances, or 96% of the time, stocks were higher 12 months later.** Similar five-month winning streaks were seen in the early stages of the 1974, 2003, and 2009 bull markets.

Stocks still appear attractive on a relative basis. Forward earnings estimates are rising at the fastest pace since coming out of the 2008 financial crisis. This rise in earnings, alongside the market correction, has led the S&P 500's price-to-earnings (P/E) ratio to reset from 23.4x in early September to 20.7x currently. This is the lowest valuation level since May. While this is still elevated on a historical basis, stocks appear attractive relative to most other assets. Moreover, the Federal Reserve last week reinforced its commitment to keep short-term rates near zero until at least 2023.

The recent setback has also served to reset much of the excesses, and markets now appear much less extended. One way to quantify this is to measure the deviation of the market's price relative to its trend, such as the 200-day average price. The S&P 500 is now less than 5% above its 200-day moving average (dma) price versus 16% in early September. The 200-dma often acts as a price support level where investors step in to buy the market on pullbacks; the market is also approaching a short-term price support level near the 3200 (+/- 25 points) level, where the market consolidated during July.

Bottom Line

Our work suggests we are still undergoing a short-term corrective period within the context of a bull market. We had been expecting a more challenging near-term environment and for markets to remain choppy as we get closer to the election. However, we do not want to lose sight of the bigger picture. Recall, despite 19 pullbacks of greater than 5%, stocks rose more than 400% during the previous bull market. We view pullbacks as the admission price to being in the market and the potential for participating in longer-term gains.

The weight of the evidence in our work still suggests the primary market trend is positive, supported by an economy in expansion, rising earnings trends, monetary stimulus, and the dearth of attractive alternatives. Stocks are likely to be at higher levels 12 months from now and outperform cash and bonds. Thus, we would advise investors who are underweight equities and can withstand the volatility, to lean into the weakness by averaging into the market.

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