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Bull Bent but not Broken

What Happened

Global markets declined around 3% on Wednesday, the worst single-day loss since early February. Growth stocks, such as technology and consumer discretionary, led to the downside, and the Nasdaq 100 had its deepest one-day loss since 2011. The S&P 500 has now declined five straight days. The Volatility Index (VIX), a gauge of investor anxiety, popped to its highest level since March. Reasons cited for the selloff included concerns surrounding earnings season, corporate profit margins, the ongoing trade skirmish with China, and technical selling.

Our Take

Markets are adjusting to a confluence of uncertainties, which will take time to digest and add to day-to-day price swings. We are, however, maintaining our *bullish but bumpier* outlook.

After the sharp market correction earlier in the year, equities had been unusually serene the past few months. In fact, the S&P 500 had just gone 74 days without so much as a 1% pullback, the third longest period of this bull market. Thus, the recent volatility feels magnified. Moreover, selloffs are always accompanied by bad news.

However, Wednesday's market action represents the 19th pullback of more than 3% in a day since this bull market began. Importantly, following these other instances, stocks were higher 95% of the time three and six months later, averaging a gain of 8% and 12%, respectively. Similarly, there have been 21 five-day losing streaks that have occurred since March 2009. Following these streaks, the S&P 500 saw gains 76% and 90% of the time, respectively, over the ensuing three- and six-month time periods.

It should also be noted that the market selloff did not start on Wednesday; weakness was already evident below the surface during the past few months. This suggests some of the uncertainty is already being factored into the market. While the S&P 500 is down only about 5% from its recent peak, less than 50% of stocks within the index have been in uptrends, small caps are down nearly 10%, semiconductors are down almost 14%, and homebuilders are down roughly 30% from their highs. Moreover, international developed markets are down 13%, and emerging markets are down more than 20%.

The good news is that, with the recent pullback, the S&P 500's forward price-to-earnings ratio (P/E) has dropped back to around 16x. This is well below the 18.5x cycle high from January. Moreover, the 15.8x to 16.0x P/E level has provided fundamental support for the market on multiple occasions since 2016.

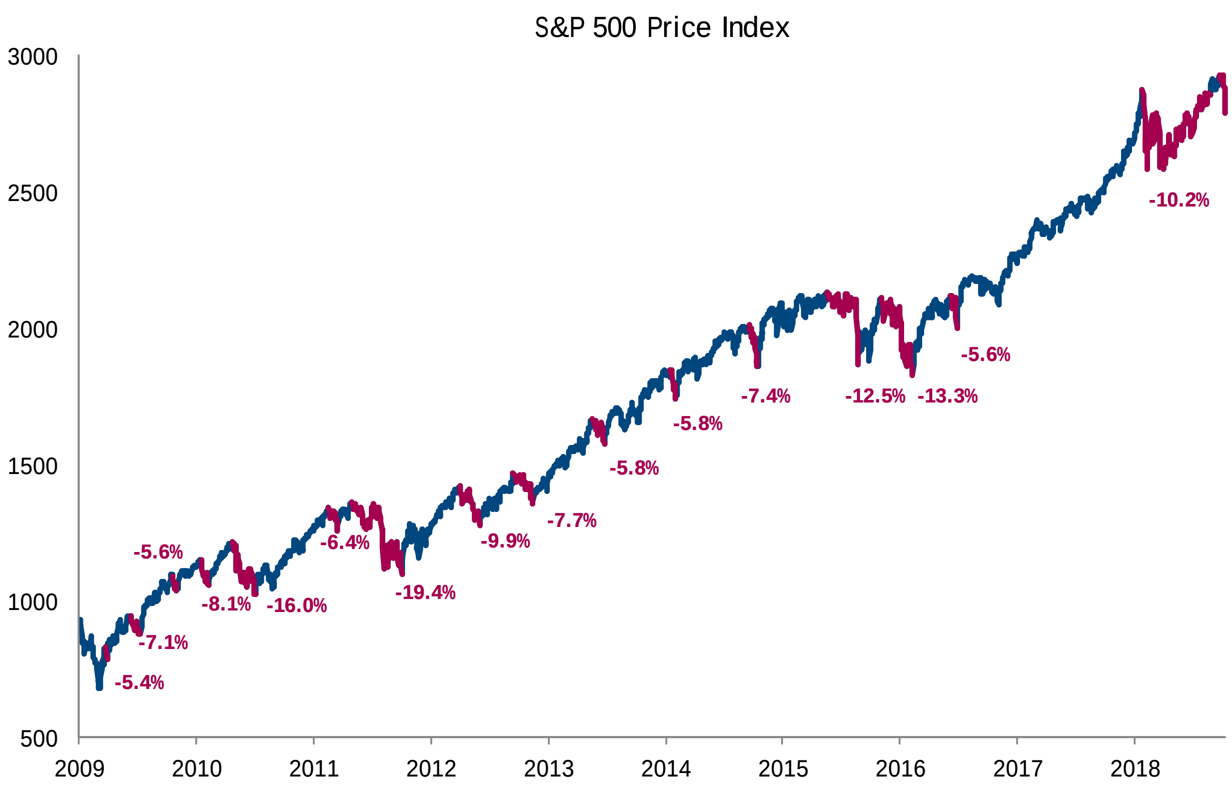
In a more negative scenario, the S&P 500 could trade down to a 14.8x to 15.0x (2575-2600) valuation level, which was the stopping place for stocks in early 2016 when fears arose about China. This would represent about 6% to 7% downside from current levels. Importantly, when inflation has been around current levels, the forward P/E has averaged 16.4 historically, so we are now a bit below average. We would also point out that the combination of the dividend and buyback yield, also known as shareholder yield, for the S&P 500 of 4.6%, provides support for equities.

There may be less upside to earnings as profit margins are hit by rising input costs, a rising dollar, and rising employment costs, but revenue growth should remain healthy. In fact, sales growth in the second quarter was 10%, the best since 2011 and should be about 7% this quarter. Also, with the Conference Board's leading economic index (LEI) at a cycle high, the ISM services index at a 21-year high, business sentiment near an all-time high, and the personal savings rate triple the level prior to the 2007 downturn, recession risk appears low.

Bottom Line

There is always the chance that this is the big one that leads to a bear market. Interest rates, China, and profit uncertainty are likely to provide challenges to the market and this adjustment period will likely go on further. However, until the weight of the evidence shifts, we suggest investors continue to give the bull market the benefit of the doubt. In a negative near-term scenario, we estimate downside for the S&P 500 should be limited to 6% to 7%. From our perspective, this is not enough to warrant making major shifts and periodic setbacks represent the admission price to the stock market. Importantly, following the other 16 pullbacks of 5% or more since this bull market began stocks averaged a gain of almost 20% over roughly the next six months.

Perspective: Current Bull Market & Pullbacks



Data Source: FactSet, SunTrust IAG

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