MARKET PERSPECTIVE

Investment Advisory Group

Keith Lerner, CFA, CMT
Managing Director, Chief Market Strategist
SunTrust Advisory Services, Inc.

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Déjà vu: Trade Escalation Leads to Another Gut Check

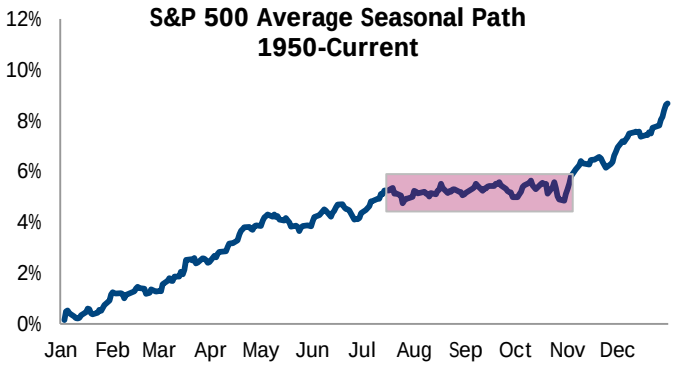
What Happened

Last week's weakness in global markets has carried over to start this week as China responded to the Trump administration's threat to extend tariffs on the remaining $300 billion in untaxed Chinese imports. China has allowed its currency, the yuan, to weaken sharply against the US dollar. A weaker yuan makes Chinese exports more competitive, offsetting some of the potential higher costs due to the proposed tariffs. This, along with reports of China possibly suspending agricultural purchases, further escalates the trade spat.

Our Take

We are seeing another gut check after stocks had the best start to a year since 1997 (through July). We already thought the environment would become more challenging over the short term heading into the seasonally weaker period of August through October (Figure 1). The latest trade escalation has served to exacerbate this typical weakness.

Figure 1: Equities in Weaker Seasonal Period



Past performance does not guarantee future results. Data Source: SunTrust IAG, FactSet

For context, we have had 18 pullbacks of at least 5% since the bull market kicked off in March 2009, all of which were accompanied by bad news (Figure 2). The median correction of this bull market has been 7.5% (average 9.6%), with wide variations. Using this as a guideline, a potential area of support for the S&P 500 would be in the vicinity of the 2750 - 2800 level (which is down about 3% - 4% from current levels). This level coincides closely with the S&P 500's 200-day moving average (currently 2791).

Figure 2: 18 Pullbacks Since Bull Market Kicked Off

S&P 500 Pullbacks of >5% Since March 2009					
Peak	**Trough**	**Duration of Decline (Calendar Days)**	**% Decline**	**Calendar Days to Next Pullback**	**Trough to Next Peak Gain**
3/26/09	3/30/09	4	-5.4%	74	20.1%
6/12/09	7/10/09	28	-7.1%	101	24.9%
10/19/09	10/30/09	11	-5.6%	81	11.0%
1/19/10	2/8/10	20	-8.1%	74	15.2%
4/23/10	7/2/10	70	-16.0%	231	31.3%
2/18/11	3/16/11	26	-6.4%	44	8.5%
4/29/11	10/3/11	157	-19.4%	182	29.1%
4/2/12	6/1/12	60	-9.9%	105	14.7%
9/14/12	11/15/12	62	-7.7%	187	23.3%
5/21/13	6/24/13	34	-5.8%	205	17.5%
1/15/14	2/3/14	19	-5.8%	227	15.5%
9/18/14	10/15/14	27	-7.4%	218	15.8%
5/21/15	8/25/15	96	-12.4%	70	13.0%
11/3/15	2/11/16	100	**-13.3%**	118	15.9%
6/8/16	6/27/16	19	**-5.6%**	580	43.6%
1/28/18	2/8/18	11	**-10.2%**	224	13.6%
9/20/18	12/24/18	95	**-19.8%**	127	25.3%
4/30/19	6/2/19	33	-6.8%	54	10.3%
7/26/19	?	7	?	?	?
average		**48**	**-9.6%**	**161**	**19.4%**
median		**31**	**-7.5%**	**123**	**15.8%**

Data Source: SunTrust IAG, FactSet

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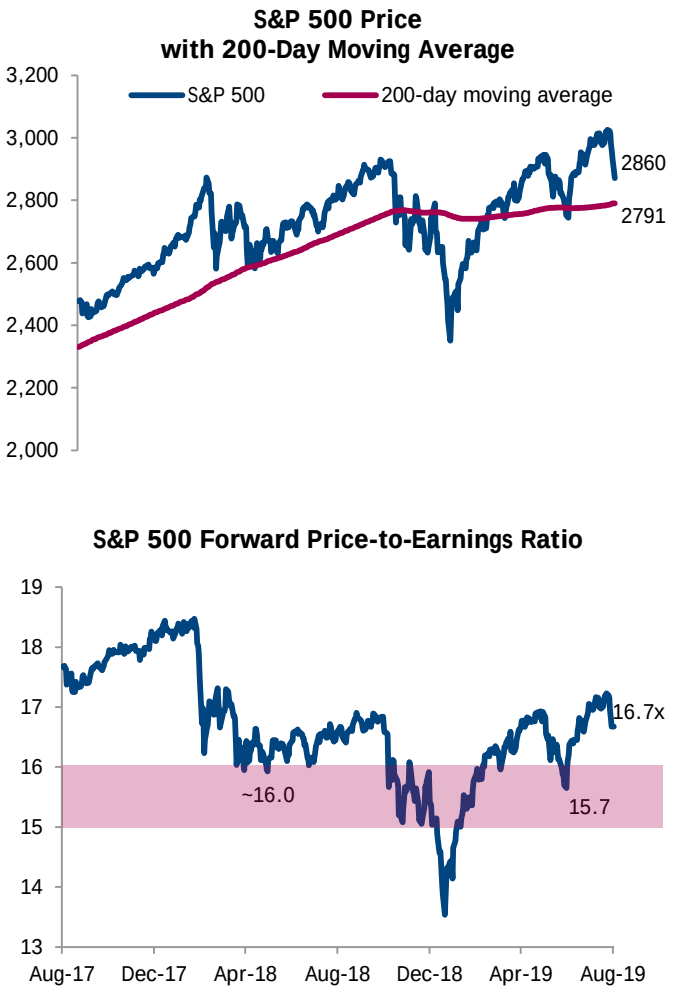
Likewise, on a fundamental basis, investors stepped in to buy stocks at a forward P/E ratio of 15.7x in June of this year. Furthermore, outside of the fourth quarter, the S&P 500 found support at a forward P/E ratio of 16.0x during 2018. Using the 15.7x – 16.0x range, and applying a forward earnings estimate of $175 (Figure 3), we arrive at the 2750 – 2800 that our technical work suggests.

Figure 3: S&P 500 Price & Fundamental Support Levels

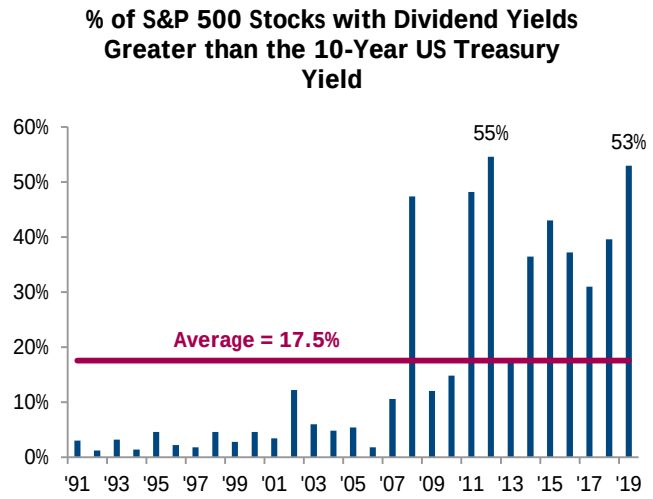


Data Source: SunTrust IAG, FactSet

We believe this is a reasonable valuation level as our work suggests the current setback should be much less severe than 2018's sharp fourth quarter decline. In 2018, many global central banks tightened policy. In contrast, today a global synchronized easing cycle is underway. If trade uncertainty persists, the Fed may feel compelled to cut interest rates more aggressively, and China will likely take additional fiscal and monetary stimulus measures.

Also, a notable difference from last year is the level of interest rates. The 10-year US Treasury yield breached 3% to the upside in the fall of 2018 compared to breaking below 1.8% today. Consequently, more than 50% of S&P 500 stocks now have a dividend yield above that of the 10-year US Treasury yield, among the highest percentages of the bull market (Figure 4). This should help buffer the downside.

Figure 4: More than 50% of Stocks have dividend Yields above bonds



Source: Strategas, SunTrust IAG, FactSet

It is important to note, however, there is also a time element to pullbacks: the median setback has lasted about 31 days (average 48 days) versus 7 days so far. The incremental tariffs are currently slated to go into effect on September 1, and the Federal Reserve is not scheduled to meet next until mid-September. Thus, we expect market conditions to remain bumpy near term.

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Bottom Line

The market is set to remain very headline driven, moving up or down on trade news. The current corrective period likely needs to run further in time and/or price. We still view the path of least resistance for the equity market as higher over the next 12 months. However, given our expectation for bouts of volatility, we have been advising exposure to high quality fixed income and non-correlated strategies to help investors cope with the *Carousel of Concerns*. Setbacks are always uncomfortable. They are always accompanied by bad news. But they are normal and the admission price to the stock market.

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