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Asian concerns driving market volatility, U.S. economy is fine…

U.S. equity markets took it on the chin last week as fears of a possible global recession escalated following weaker than expected China PMI data, a plunge in South Korean export orders (long viewed as a measuring stick for global activity), a soft U.S. ISM manufacturing report, and a solid but below expectations U.S. employment report. By week's end the Dow Jones Industrial Average fell 541 points (-3.3%) leaving it 2,196 points or 12% below its May 19th all-time high and down 9.65% on the year. The broader S&P 500 index also gave back 3.4%, pushing it back close to correction territory, 9.85% below its May 21st all-time high, and off 6.7% on the year. There was no safe haven for equity investors last week as all of the sectors in the S&P 500 fell at least 2%.

Without question the last six weeks have been challenging for investors as the severe downside volatility exhibited in equity markets seems unrelenting and never ending. This type of environment brings the perma-bears out of hibernation and the talking heads in the media seem to thrive on the turmoil as they attempt to script a narrative that explains what is going on. Human nature and emotions begin to overtake rational decision making as investors are quick to anticipate that the credit crisis that pushed markets to the brink in 2008 is just around the corner. This reaction function then takes on a self-fulfilling life of its own, undercutting confidence and prudence, until all the weak hands and much of the speculative froth gets worked off. It is at this time that patient, fundamentally grounded market participants step up to take advantage of Mr. Market's shortsightedness.

Neither I nor anyone else can tell you with complete confidence when this spasm will have run its course – clairvoyance is a characteristic for Hollywood movie heroes, not capital market prognosticators. However it is my opinion, based on our research and analysis, that this is a correction and not a prolonged bear market. That distinction is of grave importance because a correction requires an umbrella to weather the storm, but a bear market requires a bunker.

Since this bull market began in March 2009 the S&P 500 has experienced two other 10% corrections: a 16% selloff lasting 70 days from April to July in 2010, and a 19% plunge over the course of 157 days ending in October of 2011 (see chart below). Both were nerve-racking and tested the fortitude of investors, but in both cases the recovery time to recapture the market peak prior to the decline took about four to five months. Since 1950 there have been 25 bull market corrections with equities taking on average 90 days to recoup their pre-correction highs.

The low in the S&P 500 during this correction was 1867.61 on August 25th and marked a 12.4% correction. It would not be a surprise if we revisit these lows before a sustained uptrend is re-established in this bull market cycle. With that said it is important as an investor to always have perspective which suggests that if this workout period is consistent with the two other corrections in this bull market cycle, then investors should calibrate their expectations for some time around the holidays before we expect to see new highs.

One thing this correction has done is brought some much needed valuation relief to the major averages. The earnings yield on the S&P has risen to 6.4% which compares favorably to a 10-year Treasury note yielding 2.14%. Furthermore, the P/E ratio on the S&P 500 has compressed by two points from an elevated 18.5 to a more fairly valued 16.7 as of Friday's close. This is still a far cry from being cheap, but with interest rates around the globe still extremely low, stocks remain one of the better investment options relative to other asset classes.

What is driving this correction in the equity market is weak data out of Asia and fears that the second largest economy in the world, China, is slowing materially faster than expected. Unfortunately, the markets have been fixated on Asia while the data in the U.S. is healthy. For example, the S&P 500 fell 3% last Tuesday when Korean exports tumbled, the Chinese PMI data were slightly weaker than expected and U.S. data was strong. Ultimately the U.S. macro data are much more important to the U.S. stock market than data from Asia, but that is not how the market is trading.

Who will win this battle between confidence and China on the one hand and steady U.S. growth on the other hand? And could the market sell-off create a bad economy, justifying the sell-off? History shows that better data does help turn market corrections. The most dramatic example is the stock market crash of 1987. That panic was stemmed in part by 81bps in rate cuts by the Fed, however a steady diet of healthy economic data after the crash also helped.

In particular, as-reported payrolls averaged a robust 383,000 in the three months after the crash. One reason fundamentals eventually trump fear is that the negative feedback loop from equities back to the economy tends to operate very slowly. For the month or so after an equity correction, the only hard data available are pre-correction numbers. Even after the shock, the hard numbers tend to weaken with long lags. For example, a typical model of the consumer "wealth effect" assumes consumers react to the stock market change of the prior three years. Even factoring in the correction the stock market is up 35% over the last three years.

As for the strength of the U.S. economic data, last Friday's employment report was rock solid. Yes, the headline number of 173k jobs created in August was below consensus expectations for 217k, but the prior two months were revised higher by 44k. The private sector added 140,000 jobs while the government hired 33,000. The strength in government hiring was mostly teachers, as government educational services jobs increased by 32k coinciding with the start of the school year. On the private side, service sector jobs rose 164k, supported by a 62k increase in education & health services jobs. Professional & business services and leisure & hospitality both increased by 33k, trade, transportation, & utilities jobs grew by 28k, and the financial services headcount picked up by 19k. Information was the only industry that saw a reduction in jobs, falling by 7k.

Over the last three months job growth has averaged a not too shabby 221k and over the last six months it has averaged 205k. Furthermore, the unemployment rate declined to 5.1% from 5.3% and this occurred with the participation rate holding steady at 62.6%.

This report clearly shows "some" further improvement in the labor market – the 5.1% unemployment rate falls smack dab in the middle of the Fed's projections for full employment – putting the Fed front and center to potentially begin normalizing interest rates at the September 16th-17th FOMC meeting. Perhaps this is what the markets were sniffing out on Friday as investors went into risk off mode by selling stocks. However, the Fed would certainly like the markets to cooperate as they don't want to hike in the face of significant turmoil.

Economic data outside of the employment report was solid with auto sales coming in at 17.7mm, well ahead of consensus estimates for 17.3mm and average selling prices ticked up by 0.7% to $31,825. With autos and housing data chugging along like they have its hard to paint a downbeat picture on how the consumer is feeling about their finances. Furthermore, construction spending jumped 0.7% month-over-month in July (expectations were for a print of 0.6%), unchanged from the upwardly revised 0.7% month-over-month in June. This will bump up Q3 projections which are tracking in the 2.5-3.0% range.

As for the ISM manufacturing and non-manufacturing surveys, both declined on the month but both are still at expansionary levels. The ISM manufacturing index inched down to 51.1 in August form 52.7 in July and has declined for three consecutive months. This index peaked at 58.1 in August of 2014 and has been slowing almost in lock-step with the weakening growth overseas.

On the other hand the ISM non-manufacturing composite declined to a still hot 59.0 in August from 60.3 in July, but came in above expectations for a decline to 58.2. This is a significant metric, measuring the greater than 60% of the U.S economy that is serviced based and outside of July's 60.3 cycle high, the August print is the highest level seen since December 2005.

So, while the U.S. economy appears to be on firm footing and to this point has not been materially impacted by the instability emanating from around the world, it's not difficult to see why investors have become more risk averse. Global growth seems to be gearing down as lower commodity prices, slowing global trade and wobbling business confidence suggest that the pace of global activity is softening in 3Q: Brazil is on the brink of collapse, Canada is in recession, Australia is floundering with the collapse in commodity prices, Japan is muddling along, Europe has been unable to gain much traction, and China continues to search for stability. This has been visible in various economic tracking models which are suggesting that global growth is slipping below 3% – edging back to the weakened pace seen in Q1 with the deterioration led by Emerging Markets.

Last week's tepid global PMI data seems to vindicate recent market anxiety of a global slowdown as it declined to 50.7 from 51.0. Within the report it was clear that the slowdown was driven by EM with leading indicators such as new orders and new export orders heading lower. However, these same indicators edged higher for Developed Market economies, suggesting that the manufacturing economy in the developed world looks comparatively healthy and a global rebalancing is underway.

One of the major questions weighing on investor's minds and adding to capital market volatility is whether or not the struggling EM economies can drag down DM growth, therefore potentially causing a global recession? The IMF recently published a study where they concluded that a 1% hit to EM growth would have only moderate effects on DM growth, with Japan being the most exposed and most at risk. Their exercise suggests that GDP growth in the U.S. and Euro area would drop by about 0.25bp – indicating that it would take a severe slowdown in EM to derail expansions. However, it's important to acknowledge how interconnected the global economy has become and based on the reaction in capital markets to China's recent currency devaluation, it's likely that the sensitivity of Developed Market economies to Emerging Market economies is larger than estimated by the IMF study.

Developed Market central banks have taken notice with the ECB alluding to weak global growth conditions following its monetary policy meeting last week. As a result, ECB Chair Mario Draghi struck a markedly dovish tone as he hinted that he would be willing to extend the current asset purchase program beyond next September if current conditions persist. The Fed, too, is watching international developments and pondering whether to postpone interest rate liftoff at its September meeting coming up next week.

It will be interesting to ultimately see what the Fed does, on one hand they are getting the kind of confirmation they have been looking for on the economic data front in the U.S. – job growth is solid and we are nearing or at full employment while inflation has recently started to trend towards their objective. On the other hand they have to tip toe around a mixed global economic picture. Moreover, also weighing on their minds is the potential instability buried in capital market prices from the almost seven years of zero-interest-rate-policy. The time for finding out what the unintended consequences are for this unprecedented monetary policy experiment are nearing, and that too is weighing on markets.

Unfortunately, the near-term Fed outlook is in the fickle hands of the equity market. The Fed does not want to be seen as putting a floor under the market, but neither do they want to risk a meltdown in the market. Current levels of volatility as measured by the VIX index while elevated are tamer than episodes we experienced throughout other periods in this economic expansion (European Debt Crisis in 2010 and the U.S. debt downgrade in 2011). Whereby, a sustained calming of market volatility would make a rate hike more likely. Furthermore, measures of financial stress in the system only recently showed very moderate signs of stress building and it's not until these levels increase substantially higher and for an extended period of time before concern is warranted.

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