MD SASS

BEAR MARKET OR CORRECTION?

The nine year bull market and last two years of extremely low volatility were suddenly interrupted by a parabolic spike in the VIX "fear index" and violent -9.6% plunge in the S&P 500 index during the past ten days. There have been ten drawdowns of this magnitude during the past 20 years and only two of these resulted in bear markets or presaged recessions. The following are key factors regarding this selloff:

Passive and Quantitative Strategies – We believe a major difference during this correction is the dominance of passive indexing and quantitative strategies, notably exchange traded funds (ETFs), exchange traded notes (ETNs, including "short volatility strategies") and automated quantitative algorithmic-related trading. Rather than focusing on undervalued stocks, these strategies emphasize "top down" trading, which we believe exaggerated the sharp rally early in 2018 and the latest sharper decline.

Extreme Sentiment Shift - The VIX "fear index" spiked from the 10's to the 30's in only two hours in a major shift from the low volatility environment. As sentiment swiveled from euphoria (as discussed in our yearend memo) to panic, positive economic news suddenly got interpreted as bad news.

Rising Inflation and Bond Yields - The tightening labor market with rising U.S. wages (up 2.9% in January vs. expectations of 2.7%), and higher inflation and interest rates raised concerns. The increase in the 10-year Treasury to 2.85% reflects faster economic growth, spurred by stimulative tax cuts and the infrastructure plan. We view this rise in bond yields driven by higher growth and moderately higher inflation as positive economic factors, with core inflation below 2% (the low end of its range since 1960).

Valuation - The most important change for equities is price-earnings ratios are two points lower than previously at about 17.5 times 2018's estimated earnings and 16.6 times 2019's. The current S&P earnings yield is 5.9% vs. 2.9% for the 10-year Treasury, placing the spread at the high end of its historic range, and well above its median of 0.8%, since 1957.

CONCLUSION – With extreme volatility and emotional swings no one can accurately predict how long this selloff will last. However, with low real interest rates, improving global growth, strong corporate profits, cheaper equity valuations and no recession in sight, we believe this correction is offering attractive opportunities for long term investors.

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