

# Behind the correction: What's happening, why and what to do

Following a sharp decline in stock prices last week, markets plunged yesterday, with the Dow Jones Industrial Average experiencing its first 1,000-point one-day fall in history. As market gyrations continue around the world, Bob Doll and Brian Nick take a step back to offer their perspective on what's behind the fall, how long it might continue and how investors can consider responding.

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# Why are stock prices falling?

- 1) The market likely became overbought. Stock prices rose throughout 2017 and started 2018 with a dramatic increase. Strong corporate earnings, the recent tax bill and solid economic data caused investor confidence to rise. At the same time, volatility remained extremely low. We have been arguing for some time that the market appeared ripe for a correction, and that appears to be what is happening.
- 2) The dramatic rise in interest rates and hints of inflation spooked the equity markets. Interest rates shot higher in January faster than almost anyone expected. Equity markets can bear higher rates but the pace of the increase proved to be more than markets could handle. The 10-year Treasury yield jumped from 2.43% at the beginning of the year to 2.85% at its recent high. Last Friday's jobs report also included a troubling wage growth number of close to 3%, which

- exacerbated the selling last Friday and spilled into this week's declines.
- 3) Technical factors contributed to the decline. As markets started to fall, we saw signs of forced selling by automated risk-management programs and panic selling. Bid/ask spreads in the market widened dramatically and there were times yesterday when stock prices weren't quoted. This hadn't happened since the "flash crash" of 2010.

### Where might markets be heading?

- 4) We think this is a correction and not the start of a bear market. The economy and corporate earnings remain in good shape and should remain as tailwinds for stock prices. From a technical point, we would also note that commodity prices have not experienced a corresponding selloff and that U.S. interest rates are still higher than where they were at the start of the month. We think both are signals for positive economic growth.
- ongoing volatility. Upward pressure on interest rates is likely to persist and we could see additional inflation signs. Markets probably need more time before selling pressures are exhausted. The significant rise in volatility over the last few trading days and the

- slight decline in bond yields are positive signs that indicate we may be nearing the end of the "panic selling" conditions.
- 6) Markets are unlikely to go straight back up, but we think the bull market will continue. It is entirely possible that we see some sort of recovery followed by additional corrective action. But fundamentals look good and we think stocks remain fairly valued. Additionally, consensus earnings revisions have remained at close to +7% since the start of the year, which is a case for higher stock prices. A reasonable fair-value target for the S&P 500 Index could be around 2,800 or a tad higher. That would imply 2018 earnings increases of around 15% and an annual total return for stocks of about 8% for the year. Nothing that has happened recently has caused us to change those views.

### So what should investors do?

- 7) Volatility and corrections may create opportunities. For investors with a long-term time horizon, corrections may create buying opportunities. From our perspective, we are seeing areas of the market that look more attractive now than they were a couple of weeks ago.
- 8) We still think it makes sense to stick with "riskon" positions. Volatility is likely to remain elevated,
  especially compared to 2017. This is likely to cause
  additional anxiety for investors, but we continue to
  believe that equities will outperform bonds and cash in
  2018. As such, we would encourage investors to
  maintain overweight positions in stocks.

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Sources: FactSet & The Bureau of Labor Statistics

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy. The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq.

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