Article | 6 February 2018

'Healthy correction' or something more?

Sharp equity market falls have sparked concern, but strong global growth and a more robust financial system suggest strong underpinnings

Source: Shutterstock

Catalyst for a fall

The catalyst for the biggest US equity sell-off for six years is being blamed on a delayed realisation that inflation pressures are rising perhaps more quickly than anticipated (US wage growth last Friday is only one of a number of signals), which has been leading to increases in interest rate expectations and bond yields. Equity markets have finally woken-up after a period of low volatility/complacency that had led to rapid gains. Selling was then exacerbated by programme trades yesterday and the resulting market panic was the catalyst for flows into safe-have Treasuries, driving yields lower once again.

This selling pressure continued in Asia and is also being seen in Europe with equity markets opening down around 2%. However, we have to remember that yesterday's fall in the S&P500 only takes us back to the level of December 14 and equity futures are indicating a positive open on Wall Street (at the time of writing). As such, this appears to be more of a "healthy" correction rather than the start of a broader re-evaluation for earnings.

Indeed, the US economy is in great shape right now and the financial sector is in a more robust position than it was ahead of the last major sell-off. That is not to say that we won't see further falls in coming days, but in an environment where growth is good and earnings are expected to rise globally, there are decent underpinnings.

1175 Points drop in Dow Jones yesterday

What does this mean for the Fed?

Expectations for a March hike from the Fed have edged lower from around a 90% probability to an 80% probability while pricing for the end of the year has moved from just over three hikes from the Fed to just under three hikes. On what was Jerome Powell's first day as Fed Chair, comments from officials will be closely followed. James Bullard speaks today and there are four more Fed officials scheduled for tomorrow. We would expect them to tread cautiously given market sensitivities and merely repeat the mantra that the Fed will continue with "further gradual increases" in interest rates.

Indeed, one of the reasons Fed officials have cited for raising interest rates is financial stability risks, while also noting concern about "somewhat rich" asset valuations. A key quote from Janet Yellen has been that "persistently easy monetary policy might also lead to increased leverage and other developments, with adverse implications for financial stability". This is arguably a reason why equities have done so well of late; investors borrowing cheaply to put money into risk assets. Yesterday's moves may help to bring about a better sense of perspective and risk evaluation – hence the idea of a "healthy correction".

Bottom line

For choice, we still have three rate hikes pencilled in for this year, but we see the risks as skewed towards more tightening, rather than less. After all, we are forecasting 3% GDP growth, inflation to hit 3% in the summer and the strength of the labour market is finally generating some meaningful wage growth. This is also a key test for Powell as he starts his tenure, but we suspect he will be wary about being seen responding to equity market weakness rather than focusing on the economic fundamentals.

Moreover, the prospect of a March rate hike could actually get a boost today if the House of Representatives can pass a short-term funding bill that averts a government shutdown from this Thursday. Talks suggest that they are targeting a bill that would fund the government until March 23rd – two days after the March FOMC meeting.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com

Disclaimer