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Equity market sell-off update

Investment Solutions I UBS Asset Management

Luke Browne, Head of Investment Specialists, Investment Solutions and **Ryan Primmer**, Head of Investment Solutions

With US equities at an all-time high on September 20th, the nearly 10% correction that followed resulted in a flat year-to-date performance.

Global equities fell largely in-line, however most major indices outside of the US were already down year-to-date, fueled by moderating ex-US growth, associated concerns of China's deleveraging, the stronger US dollar and rising worries about trade conflicts and their impact on exports and company earnings.

What was the catalyst for the sell off?

The latest sell-off was triggered by a sharp rise in US yields (about 40 bps over 6 weeks) which was driven largely by more hawkish guidance from the US Federal Reserve. More recently, concerns about 'peak earnings' and end-of-cycle concerns have added to the selling pressure.

Third quarter earnings and guidance have been reasonably solid but a lower number of releases beating revenue estimates relative to recent quarters and increasing noise around growing margin pressures (associated with higher wages and raw materials) have led to a re-assessment of the multiple investors are willing to pay for future earnings.

Since the market's peak, the next 12-month P/E multiple on the S&P 500 has fallen from 17.5 to 15.5, which is near average since 1990. We believe this is a fairly sharp re-pricing, especially considering a generally supportive earnings season.

The outlook for global equities

Looking ahead, we expect near-term volatility to continue as the market digests recent price action and associated risks around Fed policy, earnings expectations and geopolitical events including US-China trade negotiations and the US midterm elections.

However, we believe we are much closer to the end of this drawdown than the beginning.

While 10% corrections in the S&P 500 are quite common historically, it is rare to have a bear market (greater than 20% drawdown) outside of recessions. Since 1970, there has only been one S&P 500 bear market outside of a recession, which was Black Monday, October 19th 1987.

However, as the situation currently stands, most leading economic indicators in the US remain robust, and our proprietary recession probability model signals about a 1 in 4 chance of a recession over the next 12 months—not negligible, but not our base case. There is in fact, little reason to believe the path to normalization in the US has been thrown of course. Rates will continue to rise at a gradual rate and robust growth should continue to feed through to a strong earnings environment, also witnessed in Q2.

Further, China's authorities have announced a series of monetary, fiscal and regulatory easing measures which should keep growth on track and have stabilizing effects for trade-sensitive economies from emerging markets to Europe. As the evidence of these stimulus measures begin to take hold in the data over the coming months, we'd expect markets to stabilize and present opportunities to increase allocations to select equity markets to benefit from a recovery.

In summary, while we believe another 5% decline in the S&P 500 is possible, we do not at this point expect a 20% bear market or worse. In our view, this is a re-pricing given greater appreciation of policy tightening and global risks, as opposed to a sign of an imminent end of the economic cycle.

Our views may change, however if US and global economic data begin to show genuine signs of deterioration, or if credit spreads (typically a leading indicator for a turn in the economic cycle), start to widen more severely.

How are we positioning multi-asset portfolios?

We have, over recent weeks, been migrating to a more defensive positioning in our core multi asset portfolios. This move, in anticipation of elevated risk levels, leaves us well placed to selectively deploy risk capital to take advantage of attractive investment opportunities.

Most notably, we are looking to add equity exposures at attractive entry points. Depending on how the market landscape develops, we are positive towards US equities given earnings support, emerging markets amid attractive valuations but remain mindful of trade tensions and Japanese equities which are supported by domestic reforms and monetary policy.

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