Current Market News

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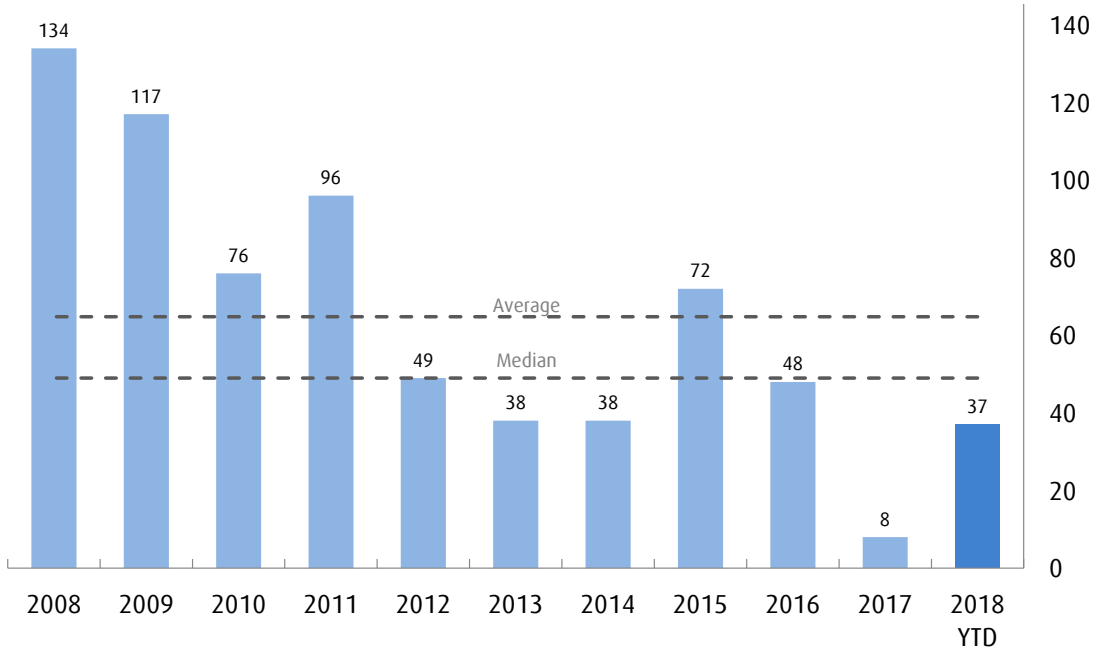
Staying the course - Market volatility returns, but economic trends remain intact

October 10th saw a jarring sell-off in the equity market with the S&P 500 tumbling almost 3.3% and the tech-heavy NASDAQ declining over 4%. The selling spilled over to the Asian markets in the evening with Japan and China experiencing similar declines. The selling was brought on by a few concerns, none of which are new, but each has come into greater focus recently. One of the headline points in our 2018 Outlook reads- "Individual risks look moderate, but collectively could pose a challenge, particularly in the second half." It is the collective nature of these risks that have likely spooked the markets. Spikes in volatility such as this typically result in continued volatility for several weeks, and overall the number of 1% or greater moves in the S&P 500 for 2018 is approaching an average range since 2008 *(Exhibit #1)*. We do not believe it is time to panic.

The concerns surrounding this bout of selling include rising interest rates on the short end from continued Fed hawkishness, as well as jumps in longer term rates that saw the 10-year Treasury yield hit 3.25% intra-day on October 9th *(Exhibit #2)*. The realization is also taking hold that trade with China is likely to take the path of greater hostility and increased tariffs. Indeed, on October 8th, largely based on an expectation of a continued U.S.-China trade standoff, the IMF lowered its global growth forecast for both 2018 and 2019 by 0.2%.

Exhibit 1: S&P 500: Number of Trading Days Closing with a Move of (plus or minus) 1% or More



Source: Bloomberg; BMO Wealth Management Strategy

Just as the market is getting news that peak growth is behind us, it is also reminded that inflation pressures are still present. At the producer level, the core rate of wholesale inflation is pushing 3%, according to the Labor Department's October 10th release. Facts on ground bear this out as well, such as the October 7th announcement from PPG Industries, the large paint and coatings company, that stated it will raise many prices by 10% to offset "unprecedented cost pressures in raw materials, distribution,

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freight, and labor." As costs get pushed down the supply chain, either efficiencies have to be found or someone will have to bear those costs.

These issues are real and present a near-term challenge for the markets. When the market mood turns negative, however, there is a tendency to spin neutral news negatively and altogether ignore positive news. For example, amid the October 10th selloff, almost completely ignored was the same-day news that the NFIB Small Business Optimism Index hit its third highest reading in its 45 years of existence. To quote the NFIB press release, "Actual capital spending in the past few months rose significantly." According to NFIB President and CEO, Juanita Duggan, "Our members say that business is booming and prospects continue to look bright."

Exhibit 2: 10-Year U.S. Treasury Bond Yield (%)

Source: Bloomberg; BMO Wealth Management Strategy

It is also important to remember that periodic corrections should be expected even in the strongest bull markets, but large and protracted declines are almost always associated with impending recessions. The New York Fed's recession probability model still shows a smaller than 15% chance of recession over the next 12 months, and our own models point to an even lower likelihood. As for the slowdown in global growth per the IMF's forecasts – it's possible, but the IMF's forecasts for the impact of a U.S. China trade war are considerably higher than many Wall Street economists' predictions. And, other than near term volatility concerns, what matters is not that we are past the peak of global growth – we knew that would come at some point before too long – but rather that the world economy has a stable path forward. We do not see the types of imbalances that were present leading up to the prior two recessions, which suggests we are not in an environment ripe for a major market decline. The economy can also well-tolerate 10-year Treasury yields at levels near 3.2% or a clip beyond; the market just needs time to be reassured that we're not on the verge of making a quick trip to 3.75% or 4%, which we do not expect.

Should these current issues continue to rattle the markets; counterbalancing forces will start to become more prominent. President Trump, for his part, frequently references the stock market and may be more inclined to cut a deal with China if the U.S. markets continued to sell off. Indeed, recent U.S. market strength may have emboldened him to take a harder line with China because our economy and markets, he surmised, can withstand the hits. The Fed too, may be less inclined to push interest rates up strongly into a volatile market. Based on CME's calculations, the probability of two or more interest rate hikes by the Fed from now through the March 2019 meeting declined from 59% on October 9th to under 48% on October 10th in the face of the equity market declines. Even the price of oil fell a few dollars on the day; the 10-year Treasury yield declined a handful of basis points, and the almighty U.S. Dollar weakened a bit. These slower moving trends won't come to the market's rescue immediately, but they certainly do provide medium-term support if the market's mood continues to sour.

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