Not 2008 or 2000. More Like 2011.

Q1 2016 Outlook & Review January Update:

We expected turbulence in the New Year. In our 2016 outlook piece we laid out expectations for another "unrewarding year" in US stocks and noted the likelihood of one, or possibly two, market corrections with increased volatility.[1] We also stressed the possible downside risks to our view that while the global economy would remain stuck in a rut, a major crisis would be avoided and a bear market was unlikely. The market's sharp decline to start the year however, has been much worse than we anticipated.

Recent market volatility seems to be driven by several (not particularly new) developments: continued slowing economic growth in China, plummeting oil prices, declines in world earnings growth, and weak and slowing global economic growth. These are, for the most part, the same factors that drove declines in the equity markets back in August 2015.

So with markets currently in a freefall, have we changed our view that a bear market is unlikely? Not really. While markets have been hit hard, we still think we are in a correction and not the beginning of a new bear market.

Now is a good time to revisit our RSVP framework, which we have outlined in other QMA pieces, to gauge the likelihood of a bear market.[2] We conclude that the odds of a bear market are still low and that the current market decline is more likely a nasty correction in the context of a continued bull market.[3]

RSVP Framework:

Recession

We would put the odds of a US recession at no more that 25-30%, even at this stage. We monitor a host of indicators that have been helpful in predicting past recessions and the vast majority still point to continued growth. While the credit markets and the US dollar are flashing yellow, the yield curve, initial unemployment claims, the PCE deflator, and a host of other indicators are still signaling green.

Shocks

The type of oil shock that has in the past sunk the economy and caused a bear market was a large spike in oil prices. Today, if a bear market/recession were to be caused by a steep decline in oil prices, it would certainly be a first. With this reverse shock, the gains should outweigh the pain, as the majority of global GDP is comprised of energy consumers rather than producers. There is mixed evidence however as to whether developed market consumers are actually spending their windfalls, while it is more certain that energy exporting countries and companies in the energy sector are indeed suffering. Further oil price declines from here on are unlikely to induce consumers to open their wallets and the pain to producers will only intensify.

Valuations

Stock market valuations were somewhat elevated before the start of this pullback but were not grossly overvalued. Given the decline that we have seen so far this year, market valuation as measured by current and forward PEs is at average levels.

Policy Mistakes

While one could argue that the Fed erred by hiking rates, we don't think that's the case. More importantly, the Fed's hands are not tied, as inflation is not a problem, and it can easily back off on its planned hikes if need be. US fiscal policy became more supportive after the recent budget deal and it's not about to turn restrictive in an election year.

The ECB and the Bank of Japan can deliver more quantitative easing, and Chinese policymakers have the resources to prop up growth further in the short term if needed.

Author

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[1] Campbell, Edward. "Q1 2016 Outlook & Review." QMA, January 2016.
[2] Keon Jr., Edward. "Fight or Flight: Thoughts on Recent Market Volatility." QMA Insights, December 2014.
[3] Our definition of a bear market is a greater than 20% decline that is not quickly reversed.