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Panic brings buying opportunities

Where are we now?

The S&P 500 index is within 2% of its 200-day moving average and, at this level, would be 12% from its peak.

The last time we saw an episode like this was the China capital flows scare of January 2016 when the market retreated -14% and, prior to this, the Flash Crash in August 2015 when the market declined -12%. In the context of where the economic recovery is now versus then, this could easily be considered a greater 'risk-off' event.

Adding weight to the view that there is some degree of 'panic' in the market, the VIX index is at its highest levels in the past five years and has spiked to twice its highest level that it experienced in the past 12 months. Indeed, since the inception of the index in 1990, it is in the top decile of observations.

However, from an economic perspective, little has changed over the past few months. The global growth outlook remains robust and synchronised, with forecasts continuing to be tilted higher. Inflation pressures, while stirring, remain modest and entirely consistent with the notion that central banks globally will be able to remove accommodative monetary policy in a very gradual manner.

We continue to view the cycle as maturing, not ending; it seems unlikely to us that some of this won't underpin further upgrades to company earnings ahead, supporting now much less demanding equity valuations. Some rise in bond yields has been anticipated, and while the recent US tax package adds some upside risk, the lack of evidence of an unexpected sharp and sustained rise in inflation ahead, should continue to support only a gradual rise in bond yields.

This time it's different

Since 1950, there have been 12 occasions where the S&P 500 index has delivered a return in excess of 5% in the month of January. Only on one of these occasions (in 1987) did the index decline in the following 11 months. Unlike in 1987, the January 2018 return of 6% was driven entirely by earnings per share revisions, rather than multiple expansion.

Rising interest rates have been limiting price/earnings expansion beyond recent (above average) multiples. Recent weakness has returned multiples to more undemanding levels, while corporate buybacks, corporate earnings growth and household demand should also support buying from here.

Panic brings buying opportunities

Against a backdrop of panic, there are some clear fundamental 'buy' signals:

- Synchronised global economic growth favours equity markets and supports a pro-cyclical exposure.
- We remain in a dividend bull market where the prospect of lower dividends for now is low.
- Equities still remain an attractive asset class versus bonds, including credit.
- Corporate earnings are still being revised higher.

We continue to see value in European equities, which is our key overweight position. We favour cyclicals over defensives and stocks with dividend growth (as opposed to dividend yield). We recently moved more underweight global bonds to reflect the likelihood that we have passed the low point in inflation.

As an interesting note, history has shown us that European equity returns over 3-month, 6-month and 12-month periods have been highest from the point at where the VIX index reaches the top decile. Once the index trades to this decile, the average 12-month return for European equities has been around 20%.

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