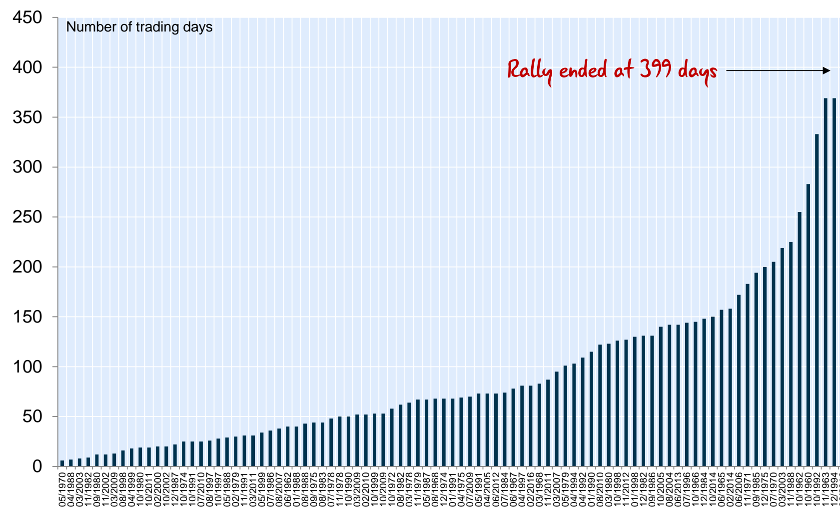
February 6, 2018

S&P 500 rally ends abruptly

It's now official. The longest S&P 500 rally since the 1960s without a 5% correction or more has ended at 399 days. The U.S. benchmark plunged 4.1% on February 5, the largest daily decline since August 2011. The S&P 500 is now down a cumulative 7.8% since its January 26th peak. Note that the pullbacks observed after the two previous longer rallies (1963-65 and 1994-1996) totalled 9.6% and 7.6%, respectively (from peak to through).

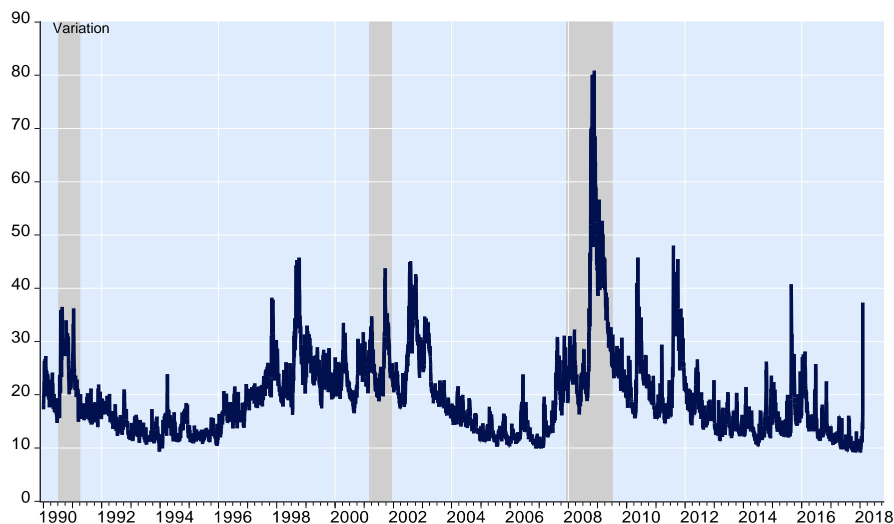
S&P 500: The longest rally since 1960 is over!
Rallies since 1960 without a 5%+ correction



NBF Economics and Strategy (data via Bloomberg as of Feb 6, 2018)

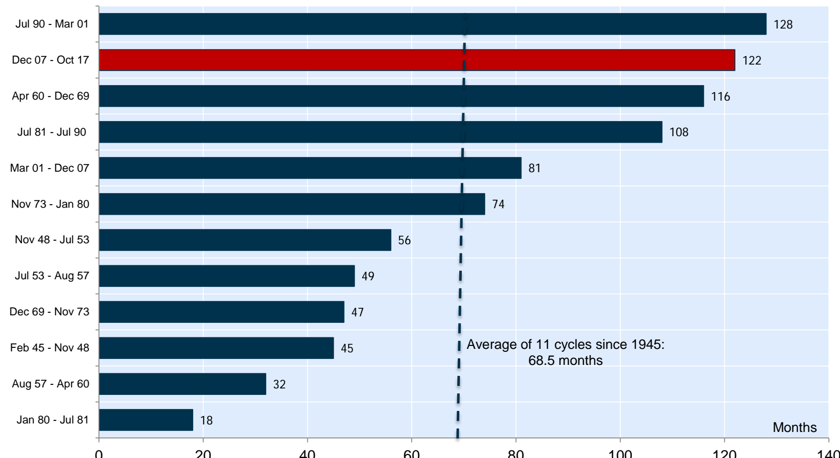
Volatility made a vengeful comeback on February 5, with a record daily increase (+20 points) that propelled VIX to its highest level since august 2015 when China surprised markets with an unexpected devaluation of the renminbi (chart).

S&P 500: The highest volatility in 29 months
S&P 500 volatility index (VIX) daily variation

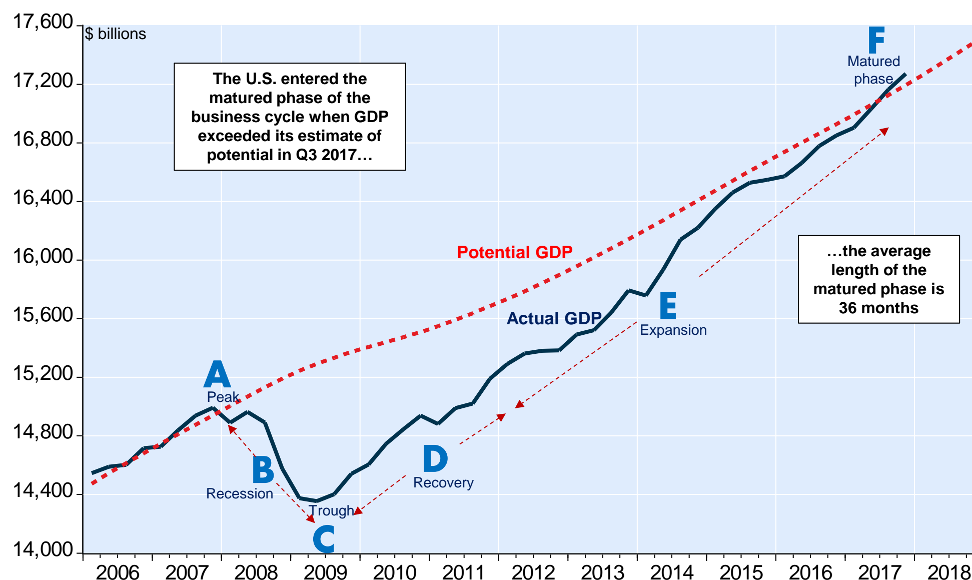


NBF Economics and Strategy (data via Bloomberg)

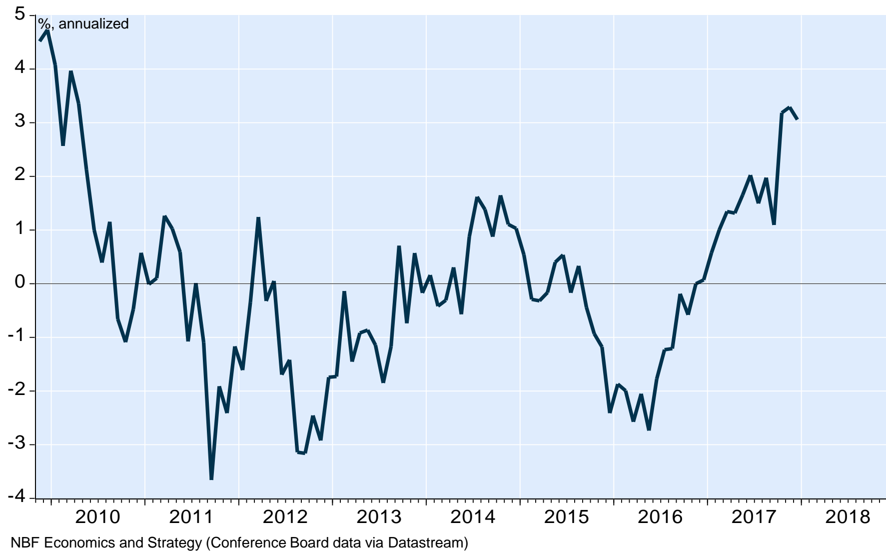
So where do we go from here? Given the longevity of the current business cycle -- it's been 122 months since the last recession -- do not be surprise to see some people calling for a much deeper correction, i.e., a bear market. We are not in that camp. The end of a stock market rally does not necessarily imply the end of the business cycle: in the 1960s, the recession actually occurred about four years after the end of the 369-day S&P 500 rally. Ditto after the end of the mid-1990s rally.



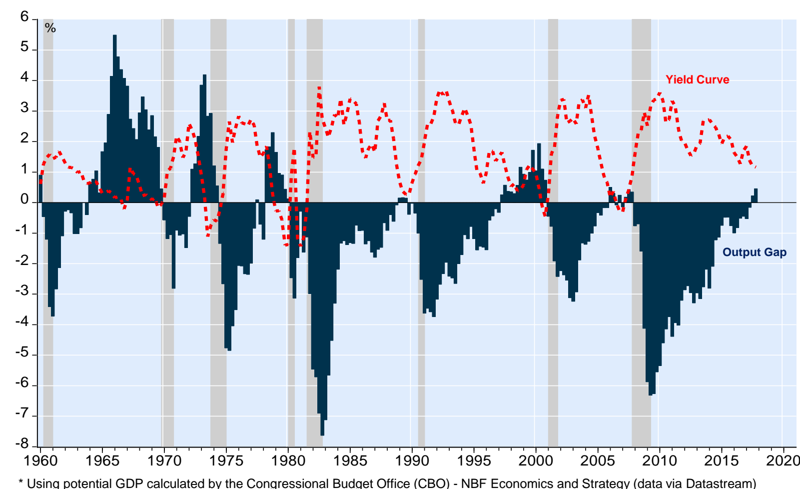
We do not anticipate a bear market because of the underlying strength of the global economy and the outlook for corporate profits. We realize that the market has been spooked by the recent rise in long-term interest but it's important to realize that we are all a little bit rusty when it comes to navigating the matured phase of the economic cycle. It's been after all over ten years since we last saw one and we may have forgotten that it's normal to see more volatility at this point in the cycle as investors reassess their convictions about the economic outlook. Our view is that the U.S. economy only recently entered the matured phase of the business cycle (when actual GDP surpasses its potential). We have been there for about six months and the average duration of the matured phase is 36 months (the shortest one lasted about 20 months in the early 1980s and longest one endured for about 70 months during the 1960s). We don't think that conditions have been met for a recession call.

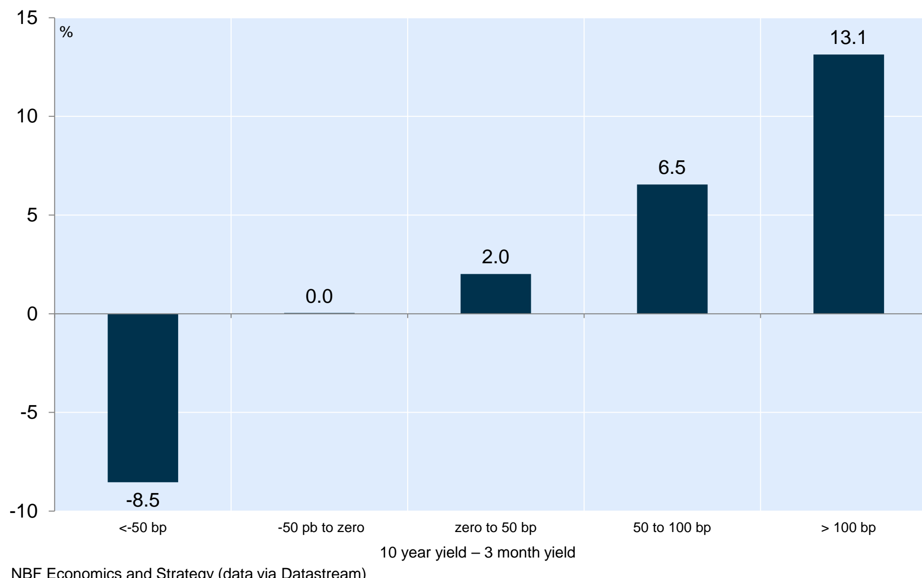


For one, the outlook for the U.S. economy has firmed in recent months. The leading economic indicator (LEI) was at a new high in December. We're especially encouraged by the strength of the LEI's nonfinancial components – the "real economy." As the chart below shows, the real economy is contributing the most since 2010 to LEI strength. This bodes well for our scenario of continuing above-potential growth in coming quarters.



For another, the yield curve remains steep for this point in the cycle (i.e. when the output gap has become positive), as unusually low inflation allows the central bank to normalize monetary policy much less aggressively than in past cycles. The current yield spread between the 10-year Treasury and the 3-month T-bill, at more than 120 bps, is well above the 50 bps that in the past has been the threshold of a signal heralding lacklustre performance of U.S. equities and rising odds of a bear market (chart). However, since the signal from the yield curve may have been muddied by successive rounds of quantitative easing by central banks, the curve slope may signal a bear market at a higher point than in the past. We have temporarily set 80 bps as the point below which we would turn cautious on equities.





Bottom-line: Despite the end of longest equity rally in U.S. modern history, we do not foresee a bear market. The global economic backdrop remains supportive for corporate profits and even though monetary policy is set to normalize further in many countries in 2018, we do not expect it to become restrictive any time soon. In our opinion, the global economic expansion still has legs. That said, it is important to remain on the watch for any unexpected pickup in inflationary pressures that could compromise the profit outlook by pushing the 10-year Treasury yield above the comfort zone of the economy. For the U.S. we peg this comfort zone at 3.0% to 3.2%. We remain well below that zone.

Stéfane Marion

Morning Comment

NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Matthieu Arseneau
Senior Economist
matthieu.arseneau@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
MD, Public Sector Research and Strategy
warren.lovely@nbc.ca

General

This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of IIROC), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

National Bank Financial Inc. or an affiliate thereof, owns or controls an equity interest in TMX Group Limited ("TMX Group") and has a nominee director serving on the TMX Group's board of directors. As such, each such investment dealer may be considered to have an economic interest in the *listing of securities on any exchange owned or operated by TMX Group, including the Toronto Stock Exchange, the TSX Venture Exchange and the Alpha Exchange. No person or company is required to obtain products or services from TMX Group or its affiliates as a condition of any such dealer supplying or continuing to supply a product or service.*

Canadian Residents

NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.

UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 71 Fenchurch Street, London, EC3M 4HD.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

National Bank of Canada Financial Inc. (NBCFI), a broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority (FINRA), and a member of the Securities Investor Protection Corporation (SIPC), is distributing this Report in the United States. NBCFI operates pursuant to a 15 a-6 Agreement with its Canadian affiliate, NBF Inc.

This Report has been prepared in whole or in part by personnel employed by non-US affiliates of NBCFI that are not registered as broker/dealers in the US. These non-US personnel are not registered as associated persons of NBCFI and are not licensed or qualified as research analysts with FINRA or any other US regulatory authority and, accordingly, may not be subject (among other things) to FINRA restrictions regarding communications by a research analyst with the subject company, public appearances by research analysts and trading securities held in a research analyst account.

The author(s) who prepared these Reports certify that this Report accurately reflects his or her personal opinions and views about the subject company or companies and its or their securities, and that no part of his/her compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed in this Report as to the securities or companies.

NBF compensates the authors of this Report from a variety of sources, and such compensation is funded by the business activities of NBF including, Institutional Equity and Fixed Income Sales and Trading, Retail Sales, the correspondent clearing business and Corporate and Investment Banking.

Because the views of its personnel may differ, members of the National Bank Financial Group may have or may in the future issue Reports that are inconsistent with this Report, or that reach conclusions different from those in this Report. To make further inquiry related to this Report, United States residents should contact their NBCFI registered representative.

This document is intended for institutional investors and is not subject to all of the independence and disclosure standards under FINRA rules applicable to debt research Reports prepared for retail investors. This Report may not be independent of the proprietary interests of NBF, NBCFI, or their affiliates. NBF, NBCFI, or their affiliates may trade the securities covered in this Report for their own account and on a discretionary basis on behalf of certain clients. Such trading interests may be contrary to the recommendation(s) offered in this Report.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA")which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright

This Report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of NBF.