
Will the global stock sell-off continue?

Weekly Market Compass: Earnings may provide support as the threats of normalization and protectionism continue

Oct 15, 2018 | Kristina Hooper, Chief Global Market Strategist

It was yet another week in which I felt like we lived 100 weeks. Of course the biggest event was the stock market sell-off. US stocks led what became a global sell-off, which slowed and actually began to reverse on Friday. The key question on investors' minds is: Is this over? Or will stocks lose more ground? Before we can gauge the likelihood of this sell-off continuing, we must understand its origins. There were two catalysts for the stock market drop - and they are the two key risks I have been warning about for more than a year: US Federal Reserve (Fed) normalization and trade.

Fed sparks concerns with seemingly hawkish comments

Recall that stocks began losing ground before the past week's selloff as the yield on the 10-year US Treasury spiked. This spike was precipitated by comments from Fed Chair Jay Powell early in the month that were perceived as hawkish. Powell posited that "we are a long way from neutral at this point," which came as a surprise because many assume we are getting close to neutral.

While I do not believe that the Fed is "going loco" (to quote recent criticism from US President Donald Trump), I do believe Powell could have chosen his words better in suggesting the Fed has a lot more tightening before it reaches neutral. But that's missing the big picture, which is that, in my view, Fed policy is inherently dangerous because the Fed is operating two levers at once: raising the fed funds rate and normalizing the Fed's balance sheet at an accelerating pace.

Fed policy was also discussed at the recent International Monetary Fund (IMF) meeting - particularly vis a vis its negative impact on emerging markets. Recall that back in early June, the governor of the Reserve Bank of India, Urjit Patel, sounded a warning bell regarding the Fed and its impact on emerging markets in a *Financial Times* op-ed piece. Since then, the situation for emerging markets has only worsened because of rising rates and the stronger US dollar - as well as country-specific issues. The Fed's response to this is a simple one; as the Fed's Vice Chairman for Supervision Randal Quarles explained, "the right response is for us to be as predictable, gradual" about policy as possible.

IMF warns of the impact of trade wars

The more immediate catalyst for the sell-off was that the downside of trade wars became tangible last week. It started with the IMF's release of its World Economic Outlook. The IMF downgraded growth estimates not just for China but for the US - and not just for the longer term but for next year.

The IMF believes the tariffs that have thus far been implemented are already having a negative impact on growth - and it forecasts that a full-blown trade war could push global growth down more than 0.8 percentage points in 2020. As IMF Chief Economist Maurice Obstfeld explained, "There are clouds on the horizon. Growth has proven to be less balanced than we had hoped. Not only have some downside risks we identified in the last WEO (World Economic Outlook) been realized, the likelihood of further negative shocks to our growth forecast has risen." Moreover, this was a very pessimistic IMF meeting, with many who attended sounding the alarm on trends, such as de-globalization, that are threatening global growth.

More volatility ahead?

These risks have been growing for some time, and so I don't expect them to go away overnight. Therefore I don't believe the sell-off is over. I expect increased volatility to continue, especially downside volatility. However, I also expect earnings to provide a powerful source of support to stocks. In addition, the yield on the 10-year US Treasury has moved down substantially, taking pressure off stocks. In other words, I believe the sell-off will be relatively short-lived and resemble the February sell-off, unless one of the two key risks I discussed accelerates dramatically. In this environment, I believe that skilled active managers can play defense on the downside and take advantage of opportunities as they arise.

Four things to watch this week

Beyond the sell-off, there is a lot going on in the coming week that we will need to pay attention to, including:

- **Italian bond yields.** The Italian 10-year bond yield rose to 3.57% from 3.42% over the past week, as Italy moved forward with plans to spend more in the next several years than allowed by the European Union (EU).¹ The EU has made it clear that this puts Italy in breach of EU covenants. At the same time, the yield on the German bund fell to 0.50%, despite some geopolitical stress created by the election in Bavaria.¹ That election has starkly illustrated the drop in support for the Christian Social Union (CSU), which in turn would suggest an erosion in support for German Chancellor Angela Merkel. The spread between the Italian 10-year and the German 10-year has widened so much that it is concerning. We will want to see how the EU handles this lack of fiscal discipline from Italy, as it could precipitate a move by Italy to leave the EU - or at least fray ties even more. I wouldn't be surprised to see Italian bond yields rise further in this environment as uncertainty grows.
- **EU summit.** The European Union will hold a summit this week, and has been working furiously with the UK in order to arrive at an outline of a Brexit agreement by the summit - although it looks like it will not have an agreement outline by then. This calls into question the rest of the timeline. The goal was to then refine the outline following the summit, and come to a legally binding agreement at the November summit. We will want to follow the situation closely, including whether the EU and UK extend the post-Brexit transition period, which would allow both sides more time to negotiate the terms of a post-Brexit trade relationship. This only adds to geopolitical stress and economic policy uncertainty.
- **US Treasury biannual report.** US Treasury Secretary Steve Mnuchin is expected to release a Treasury Department report that will include an assessment of foreign currencies. There are some worries that the US will label China as a currency manipulator in this report - despite leaks from the US Treasury that China is not manipulating its currency. If the report does this, it will only intensify tensions between the US and China.
- Third quarter corporate earnings season has begun, and I expect them to be very good overall. However, more than actual earnings, I care about what companies will be messaging about the future. Recall that last week we heard from several companies, including Fastenal, which shared that the tariff conflict is already disrupting its global supply chain. Therefore, I will be particularly focused on what companies have to say about trade tensions and their impact on earnings.

Source

¹Bloomberg, L.P., as of Oct. 12, 2018

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