US Equity Correction? Prepare, Don’t Panic
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Political noise emanating from Washington has prompted fresh concerns that a US equity market correction may be looming. But have no fear: the market often takes a leg down, only to bounce back quickly.

US stocks have enjoyed a powerful rally since the election of Donald Trump as president in November. The S&P 500 Index advanced by 13.4% from the election through May 23, on hopes that the new administration’s policies—including tax cuts, deregulation and repatriation of corporate cash held overseas—would boost economic growth and earnings. Now, with the president facing major political challenges, investors are concerned that the optimism may have been premature.

GAUGING THE WARNING SIGNS

US equity valuations are one of the key concerns today. The S&P 500 is trading at a price/forward earnings ratio of 17.9×, which is relatively high in historical perspective. While these valuations are supported by strong profitability, investors are questioning whether margins can continue to improve as they have over the last few years. And volatility has been extremely low, until it spiked last Wednesday. These conditions, together with political uncertainty, suggest that stocks could be vulnerable to a change in sentiment.

But let’s put the economy and the market in perspective. It’s true that first-quarter GDP growth was disappointing as consumer spending slowed. Yet many positive trends, including low unemployment and upbeat business surveys, were in place well before the election and point to solid growth ahead. There are also encouraging growth signals in other parts of the world, in particular both Japan and Europe.

DRAWDOWNS ARE COMMON IN STRONG YEARS FOR STOCKS

Market trends also require context. At some point during 20 of the last 37 years, US equities have been hit by a peak-to-trough decline of at least 10% (Display). These episodes always trigger anxiety and make investors search for the exits. Yet, the bounceback is often very quick. Stocks have posted full-year declines in just six of those 20 years.
Dumping stocks during a decline is usually a mistake. Since stocks have delivered positive annual returns in most years, getting out of the market during a sharp correction often means locking in losses and forfeiting returns in a rebound. And it’s almost impossible to time market inflection points.

Today’s extremely low volatility levels have reinforced investors’ complacency. It’s easy to forget how often equity corrections happen—and how quickly the market tends to rebound. That’s why it’s so important to keep the historical context in mind before the market takes a hit.

CORRECTIONS CREATE OPPORTUNITIES

As the term suggests, a “correction” isn’t necessarily all bad news. With the Fed reining in the supply of “free” money and interest rates poised to rise, companies will need to up their game and adjust. This environment could foster a more traditional business cycle than we’ve seen over the past decade. And higher rates could help investors distinguish companies whose margins are driven by solid business models, growth prospects and effective management teams from those who have relied too heavily on low interest rates to artificially buoy profitability. Active equity managers can exploit bouts of volatility to build positions in companies that have long-term staying power in the changing environment.

It might sound counterintuitive, but there’s really no reason to panic when stocks fall. Corrections are often the best time to add to an equity allocation. And over the long term, we believe that maintaining a long-term strategic position in equities is the best way for investors to preserve purchasing power by compounding gains.

Market corrections always feel painful. But they’re also extremely common. By bracing for a correction—and understanding that they’re usually fleeting—investors can gain the confidence to stick with an equity allocation, and are likely to be rewarded over time for their patience.
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