

ClearBridge

Investments

The Long View



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"History doesn't repeat itself, but it often rhymes."

—Attributed to Mark Twain

Key Takeaways

- ▶ Given a mostly healthy ClearBridge Recession Risk Dashboard, we expect the current market turmoil will be relatively short and not reach the severity that typically coincides with a recessionary market crash.
- ▶ We believe a great deal of negative news is now priced into the market, which should allow for positive surprises relative to expectations.
- ▶ The current environment is similar to several previous periods where market weakness and substantial P/E compression occurred against a backdrop of economic and earnings strength. Historically, these periods have been followed by solid stock rebounds.

Equities Enduring Pullback, Not a Crash

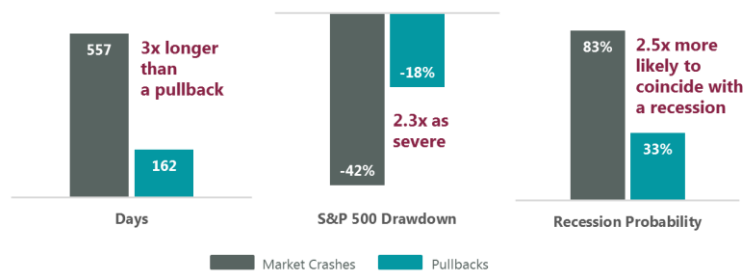
As legendary investor Sir John Templeton once said, "The four most dangerous words in investing may be 'this time is different'." Many investors, both professional and individual, have uttered this phrase only to be proved disastrously wrong. The fourth quarter's market carnage has conjured up memories of 2008's drawdowns and ignited a debate about the timing of the next recession. In short order, the S&P 500 Index fell 19% from its late-September peak, vindicating the bears. With liquidity tightening, some are calling for investors to prepare for further drawdowns in equities. But is the fear of a market crash warranted?

First, we must define what constitutes a market crash. At ClearBridge, we define market crashes as drawdowns of 20% (or more) that last longer than one year. By contrast, we define other large selloffs (15% or more) that last less than one year as pullbacks. This added dimension of time is an important one as many investors may be able to ride out the shorter-term turmoil of a pullback but will feel the impacts of a market crash on their portfolio much more severely. Through this lens, it becomes clear that market crashes and recessions typically go hand in hand. Market crashes typically last three times longer and experience drawdowns 2.3 times more severe as compared with pullbacks. Most importantly, market crashes are 2.5 times more likely to coincide with recessions, historically.

Exhibit 1: S&P 500 Market Crashes vs. Pullbacks

Market Crashes				
Peak	Trough	Days	S&P 500	Recession
Nov. 1968	May 1970	543	-36%	Yes
Jan. 1973	Oct. 1974	630	-48%	Yes
Nov. 1980	Aug. 1982	621	-27%	Yes
Aug. 1987	Dec. 1987	101	-34%	No
March 2000	Oct. 2002	929	-49%	Yes
Oct. 2007	March 2009	517	-57%	Yes
Average		557	-42%	83%

Pullbacks				
Peak	Trough	Days	S&P 500	Recession
Sept. 1976	March 1978	531	-19%	No
Feb. 1980	March 1980	43	-17%	Yes
July 1990	Oct. 1990	87	-20%	Yes
July 1998	Oct. 1998	83	-19%	No
April 2010	July 2010	70	-16%	No
April 2011	Oct. 2011	157	-19%	No
Average		162	-18%	33%



Market Crashes defined as decline of 20% or greater in S&P 500 lasting at least 1 year. Pullbacks defined as declines of 15% or greater in S&P 500 (no time component). 1987 decline persisted at 20% or greater loss 1 year after Aug-87 peak despite trough coming in Dec-87. Source: S&P, NBER, and Bloomberg.

Put differently, five of the past six market crashes have been linked with a recession. The sixth happened in 1987 which, in our view, is not a proper analogue to current conditions. 1987 had seen a dramatic move in long-term interest rates from 6% to 9% and a 30% intra-year rally in equities. Against this backdrop, the portfolio insurance unwind caused the largest one-day drawdown in market history, known as Black Monday. At present, the backdrop is far

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tamer with Treasury yields up just over 20 basis points in 2018, a far more muted stock market decline and no obvious catalyst that could spark a waterfall moment.

Therefore, we believe the key question for investors in 2019 is whether the U.S. is heading into an economic downturn. The ClearBridge Recession Risk Dashboard would suggest that these fears may be overblown, with eight green indicators, four yellow, and zero red (Exhibit 2). While this is not as sanguine a picture as the one painted last month it remains quite healthy overall.

Exhibit 2: ClearBridge Recession Risk Dashboard

		Fourth Quarter 2018	Third Quarter 2018
Financial	Yield Curve	●	↑
	Credit Spreads	●	↑
	Money Supply	●	●
Inflation	Wage Growth	↑	↑
	Commodities	●	↑
Consumer	Housing Permits	↑	↑
	Jobless Claims	↑	↑
	Retail Sales	↑	↑
	Job Sentiment	↑	↑
Business Activity	ISM New Orders	↑	↑
	Profit Margins	↑	↑
	Truck Shipments	↑	↑
Overall Signal		↑	↑

↑ Expansion
● Caution
× Recession

Data as of Dec. 31, 2018. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg.

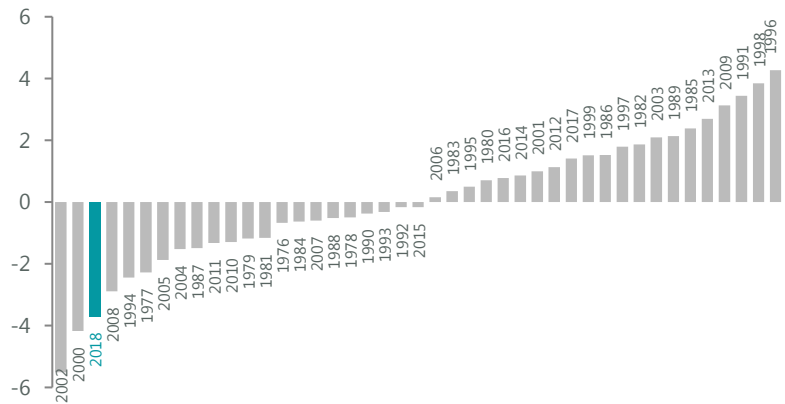
The financial markets component of the dashboard now has all three signals flashing yellow, along with a fresh downgrade for commodities. By contrast, the consumer and business segments of the dashboard remain solidly green. As a result, it is important for investors to ask themselves the question posed earlier: will this time be different, i.e. will a market crash ensue without a recession? Given the health of the ClearBridge dashboard, we believe that the current market turmoil will be relatively short-lived, rendering this period a pullback rather than a market crash.

While it can be hard to pinpoint the level at which equities find a bottom, it is important to view non-recessionary pullbacks through three dimensions: [price, time and sentiment](#). While several sentiment surveys have ticked down recently, they remain at

elevated levels broadly speaking. Overall, we believe we may be close to an inflection point.

One casualty of the recent market volatility has been price-to-earnings (P/E) multiples. The combination of a strong earnings environment and a negative return has brought valuations down considerably. In fact, 2018 witnessed the third greatest annual decline in P/E levels over the past four decades (Exhibit 3), even greater than the P/E compression experienced in 2008.

Exhibit 3: Third Greatest Decline in P/Es in Past 40 Years



Data as of Dec. 31, 2018.
Source: Credit Suisse and S&P 500.

Today, the market multiple is near five-year lows, a level consistent with the last two major growth scares. Importantly, P/E contraction has been concentrated in cyclical sectors, which we believe are overly discounting the chances of a recession in the new year. We believe a great deal of negative news is now priced into the market, which should allow for positive surprises relative to expectations.

It is often said that history doesn't repeat itself, but it does rhyme. The current backdrop shares several attributes with both 1984 and 1994, most notably a strong economy, robust earnings growth, substantial P/E compression and a weak stock market.

In 1984, earnings growth was 21%, real GDP was roughly 7%, P/E multiples contracted by two turns, and the market finished +2% for the year. Similarly, in 1994, earnings growth was 19%, real GDP was 4%, P/E multiples came in three turns and the market was down 1.5%. Importantly, after each of these years of lowered expectations and derating, the market bounced back, experiencing a 26% return in 1985 and a 35% gain in 1995. In our view, the key component to these bounce-backs was the lack of a recession in the year following the resetting of expectations.

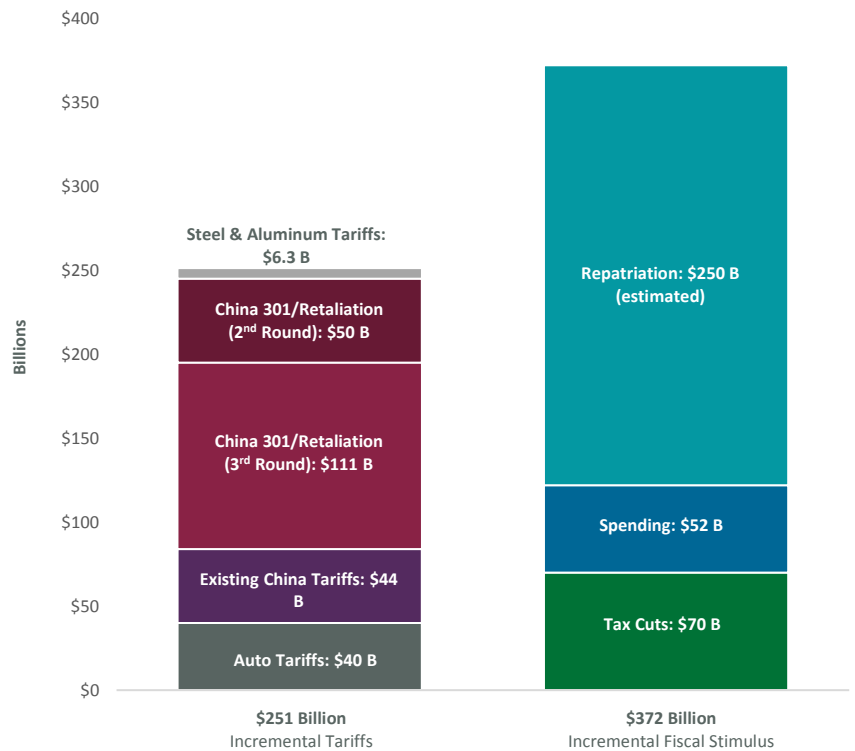
The current environment also has several similarities to a more recent historical period, 2015-16. Falling crude oil, a hawkish Fed, U.S. dollar strength and Chinese weakness all contributed to a bout of market volatility in late 2015 and early 2016. Despite these negatives, the U.S. avoided a recession, Chinese stimulus took effect and a hard landing was avoided, the Fed slowed its pace of interest rate hikes and the greenback steadied. 2016 and 2017 both experienced solid returns for global equities, with double-digit returns for the S&P 500 in each year.

While several fears today echo those of late 2015, we are already starting to see some of the stabilizing mechanisms from early 2016 emerge. First, oil prices may have found support following the OPEC decision to cut supply. Second, Chinese authorities have performed over 50 different easing moves in the past six months which are starting to translate into green shoots in areas like infrastructure, total social financing and services PMI data. Although further Chinese stimulus may ultimately be needed, a rebound in Chinese activity could once again be an important driver for the global economy and a catalyst for a sharp rebound in global equities.

Several risks do remain for stocks, including trade tensions, slowing earnings growth and a policy error by the Federal Reserve. While Fed Chairman Powell's comments last month were initially perceived as quite hawkish, we believe Fed Governor John Williams' comments two days later are quite important. Mr. Williams stated that the Fed is not on "autopilot" or any predefined course for rate hikes or quantitative tightening, reiterating that the U.S. central bank is listening to markets and the economy (aka being data dependent). With inflationary pressures receding, the Fed has breathing room to normalize policy more slowly in 2019 and avoid a policy error.

Tariffs are likely to remain in the headlines over the next several months as negotiations between the U.S. and China continue. While these headlines can rattle investors, the ultimate impact is likely to remain manageable for both the economy and individual companies. Most businesses are likely to utilize a combination of supply chain reorganization (substitution of suppliers) and price increases to offset much of the impact of higher input costs from tariffs. By passing along the cost of the tariff to a mix of suppliers and consumers, business should be able to preserve margins.

Exhibit 4: Fiscal Stimulus > Trade Concerns



Data as of Dec. 31, 2018.
 Source: Strategas Research Partners.

From an economic perspective, we believe it is illustrative to examine the “worst-case” scenario. As shown in Exhibit 4, if all the various tariffs discussed were to be implemented at their highest rate, and China was to retaliate in-kind, the incremental burden on the U.S. economy in 2019 would amount to \$251 billion. This remains smaller than the amount of stimulus expected to enter the economy in the new year (\$372 billion).

A final investor fear is that the market cannot rally further as the economy slows and earnings growth cools. Although there is little question that GDP growth will decline after this year’s strong run, the economy is likely to still operate in the mid-to-low 2% range. Importantly, there is a difference between a slowdown off tough comparisons (with upside from tax reform) and a rollover ahead of a recession. Historically, peak earnings growth does not necessarily mean the end of the economic or market cycle (Exhibit 5). In fact, peak earnings growth has preceded recessions by over three years on average and the S&P 500 has seen an average return of approximately 40% over such periods.

Exhibit 5: Peak Earnings A Reason to Sell?

EPS Peak (S&P 500)	Recession	# Months	S&P 500 Return (%)
3Q62	4Q69	87	63.6
1Q66	4Q69	45	3.2
4Q68	4Q69	12	-11.4
4Q73	4Q73	-1	1.7
4Q76	1Q80	37	6.2
3Q79	1Q80	4	4.4
3Q81	3Q81	-2	-11.3
2Q84	3Q90	73	132.5
2Q88	3Q90	25	30.2
3Q93	1Q01	90	152.8
2Q95	1Q01	69	113.0
1Q97	1Q01	48	53.3
1Q00	1Q01	12	-22.6
3Q02	4Q07	63	80.1
1Q04	4Q07	45	30.4
3Q06	4Q07	15	9.9
Average (1962-2006)		39	39.8
4Q10	-	96	99.3
2Q14	-	54	27.9
3Q18?	-	-	-
Avg. Incl. Current (1962-Present)		43	42.4

Note: Peak EPS based on YoY trailing EPS growth.
Source: Credit Suisse, S&P, NBER, and Bloomberg.

While the current environment certainly has its fair share of risks, we believe these ultimately will be bricks in the wall of worry that the market climbs higher in 2019. Our view is predicated on the health of the ClearBridge Recession Risk Dashboard in addition to other important signposts such as a healthy consumer and solid business activity. As we look toward the new year, this healthy fundamental backdrop combined with attractive equity market valuations, a potential Fed pause and more Chinese stimulus all point toward a market rebound rather than a prolonged crash.

Best wishes for a happy, healthy, and successful 2019 and thank you for your continued support.

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