IG WEALTH MANAGEMENT

Special market update

Special market update – May 6, 2022

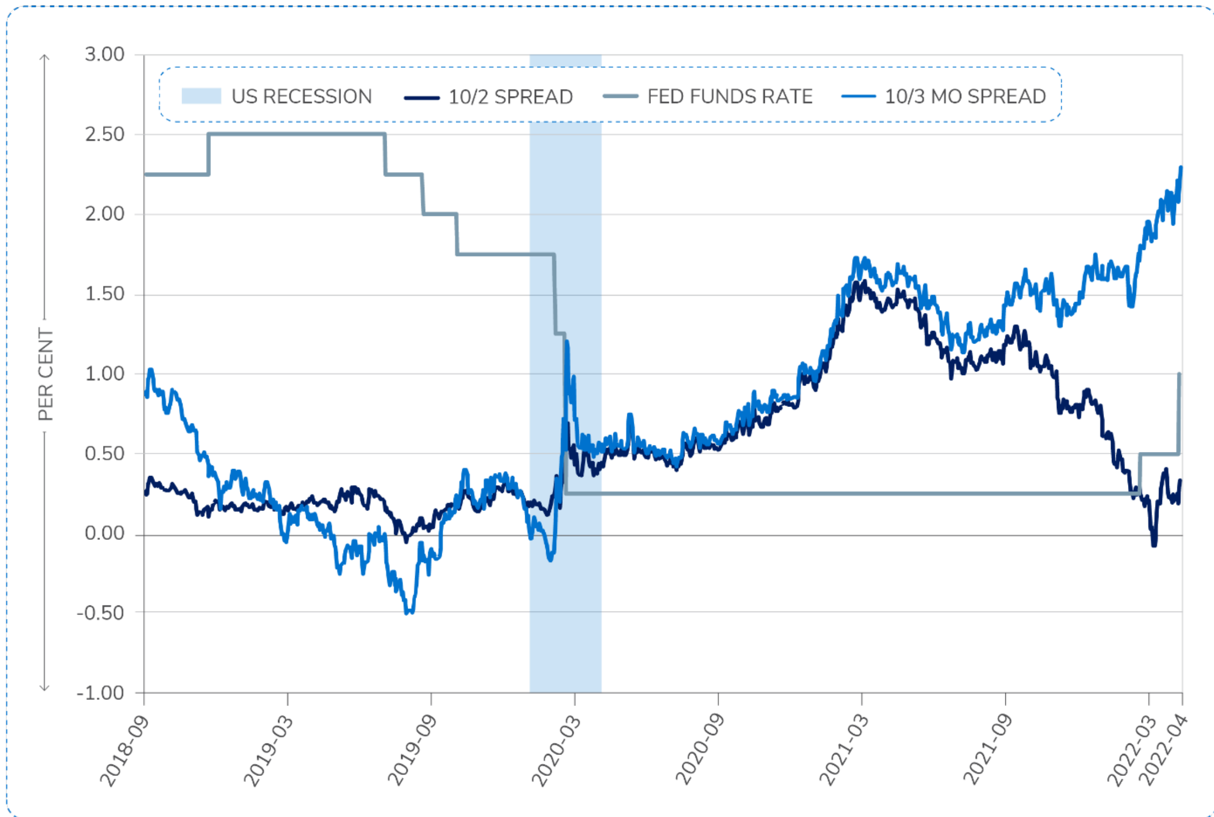
It has been a challenging start to the year, to say the least. The S&P 500 Index suffered its worst start to the year through April since 1939. As of market close Thursday May 5, the S&P 500 Index had fallen 13.5% from its high reached on January 3. The S&P/TSX Composite Index has fared better, with a drop of 6.3% from its high on March 29 (and is -2.3% year-to-date).

Fixed income, a typical safe haven in times of equity volatility has also suffered an unusually poor start to the year. The FTSE Canadian Universe Index, a benchmark for Canadian bonds, has fallen 11.1% year-to-date. Higher inflation and the resulting sharp rise in yields have not only presented a challenge for bond investors but have contributed to equity market volatility. So are the weaker markets so far into 2022 a sign of a more ominous economic environment? Or is the recent activity merely a typical valuation correction and part of a normally functioning market? In order to answer this question, we need to assess where we are in the economic cycle and answer the question: are we heading towards a recession?

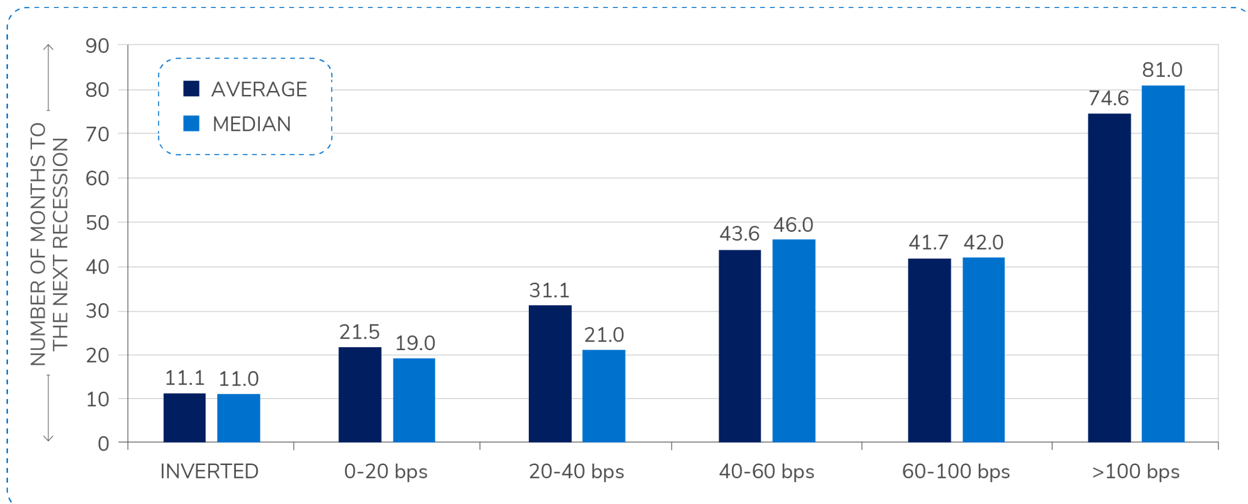
Recessions in the United States are usually preceded by certain market conditions. These include rising unemployment, falling manufacturing and housing activity, tighter credit conditions, inflation, negative leading economic indicators and an inverted yield curve, to name a few of the more common ones. This is where I struggle to find any meaningful increase in economic risk over the coming 12 months.

At the beginning of April, many eyes were focused on the U.S. treasury yield curve, in particular, the 10-2 spread. This is a measure of long-term yields against short-term yields. Every recession since 1970 has been preceded by an inverted yield curve (a condition when short-term yields are higher than long-term yields). For a period of three days at the beginning of April the 10-2 curve inverted. However, the keen observer would have noted that a true signal is when the yield curve remains inverted for a period of a few months and is confirmed by and inversion of the 10-year/3-month curve: that didn’t happen. I would suggest that the inverted yield curve was a false signal. Further, since the beginning of April, the yield curve has steepened. At its current level (32 basis points as of May 5) history would suggest the average duration to recession is 31 months (since 1976).

The federal funds rate versus the 10/2 yield curve spread (2018 through May 5, 2022)



How many months until the next recession when the yield curve flattens YOY? (1976-2020)



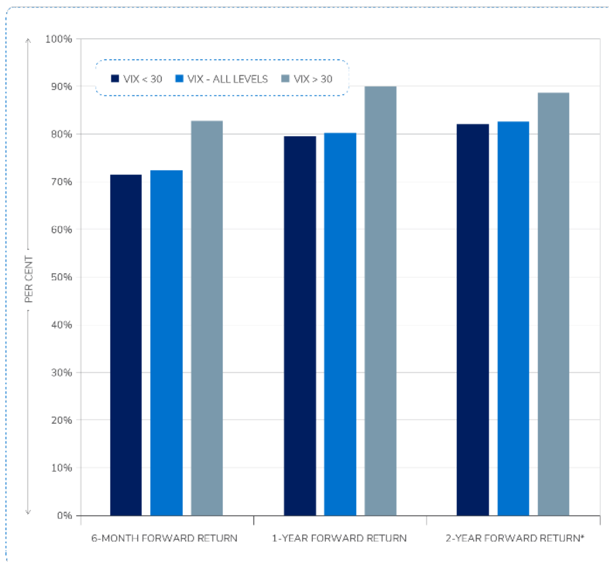
What about the other preconditions? Up until now, there has been a lack of meaningful evidence of heightened economic risk that would suggest a pending recession. Unemployment in the United States currently sits at 3.6%, a mere 0.1% above the pre-COVID-19 low. The number of Americans on unemployment benefits is at a low not seen since 1969. And housing starts, an important component to the American economy, have been accelerating on a 12-month moving average basis.

I would acknowledge that as central banks in Canada, the United States and around the world raise their benchmark policy rates, economic growth will slow. But let’s not mistake slowing economic growth for a recession. Therefore, if the risk of recession hasn’t increased in a meaningful way — which I don’t believe it has — this market volatility may be best characterized as normal.

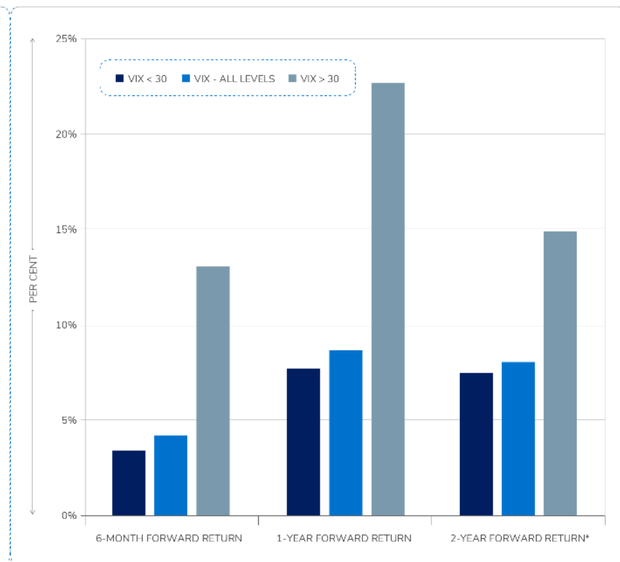
There have been 22 corrections since 1945, and an additional 11 bear markets for the S&P 500 Index. Of the 22 corrections, the average drawdown was 14.3%, with a duration of 93 trading days. This current correction has seen a top-to-bottom drawdown of 13.8% over 81 days to its recent low. From the correction low, the 1-year return for the S&P 500 Index has averaged 25.1%. We can never say for certain if we have hit the bottom of the correction until well after the fact, however, there have been encouraging signs.

The CBOE Volatility Index, also known as the VIX, has broken above 30. This has been a good level in the past to mark the formation of a bottom. Since 1990, following periods when the VIX exceeded 30, the S&P 500 Index has gained over the next 12 months, 90% of the time, with an average gain of 22.7%. In addition to the VIX, the put/call ratio for the S&P 500 Index reached 1.1 on April 29, the near-term low. The put/call ratio can be used as an indication of how much protection investors are buying in the current market. The higher the ratio, the more protection. An intra-day ratio of 1.1 has occurred only 3% of the time on a daily basis since 1995. Ninety-two per cent of the time the S&P 500 Index has gained in the following 12-months, with an average gain of 14.4%.

S&P 500 Index: probability of positive 6-month, 1-year and 2-years forward returns
VIX Index greater than 30, less than 30 and all levels (1990-current)

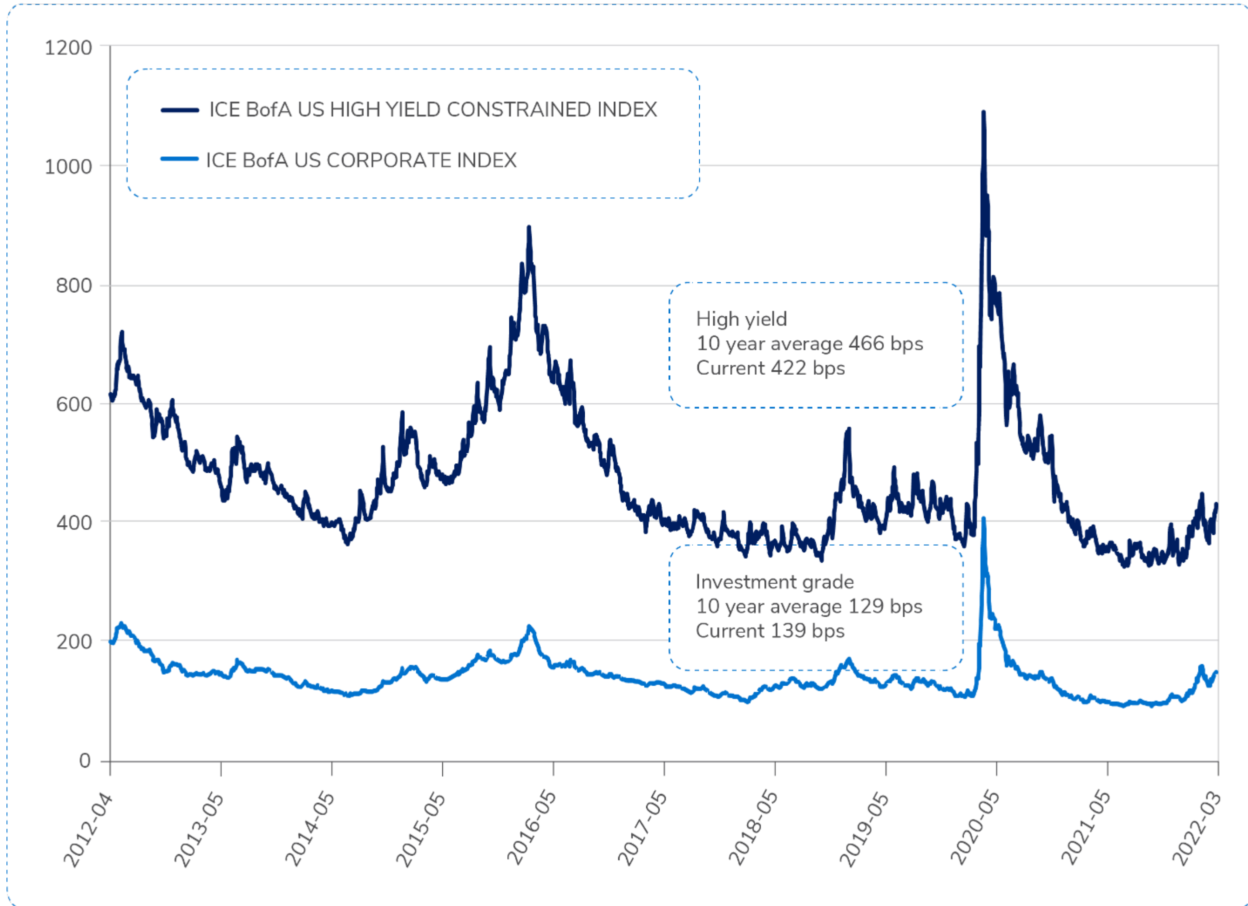


S&P 500 Index: 6-month, 1-year and 2-years* forward returns
VIX Index greater than 30, less than 30 and all levels (1990-current)



One other aspect that leads me to believe this is nothing more than a typical market correction, is the fact that the credit markets don’t seem to be in line with the supposed economic risk that some are attributing to the equity volatility. Specifically, we would expect to see credit spreads widen out on potential economic risk factors. What that means is that the yield demanded by investors to own corporate debt, whether investment grade or high yield, typically increases significantly above government bond yields. This hasn’t happened through this correction. The spread between high yield bonds and government bonds has widened but remains in line with the long-term average. Based on credit spreads, the bond markets are not suggesting we are heading into a recession.

Credit spreads wouldn't suggest economic risk
High yield and investment grade bond spreads (last 10 years)



Corrections are uncomfortable: they're supposed to be. They shake investors' confidence and test their resolve, resetting expectations along the way. It is difficult to argue that this correction is any different.

If history is a guide, investors would be well served to look past the current volatility that has merely taken equity markets back to where they were a year ago and remain focused on their long-term goals. In fact, this may be the opportunity for investors who have been waiting for an entry point into equities.

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