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MARKET SIGHT LINES

Trouble Ahead for Stocks?

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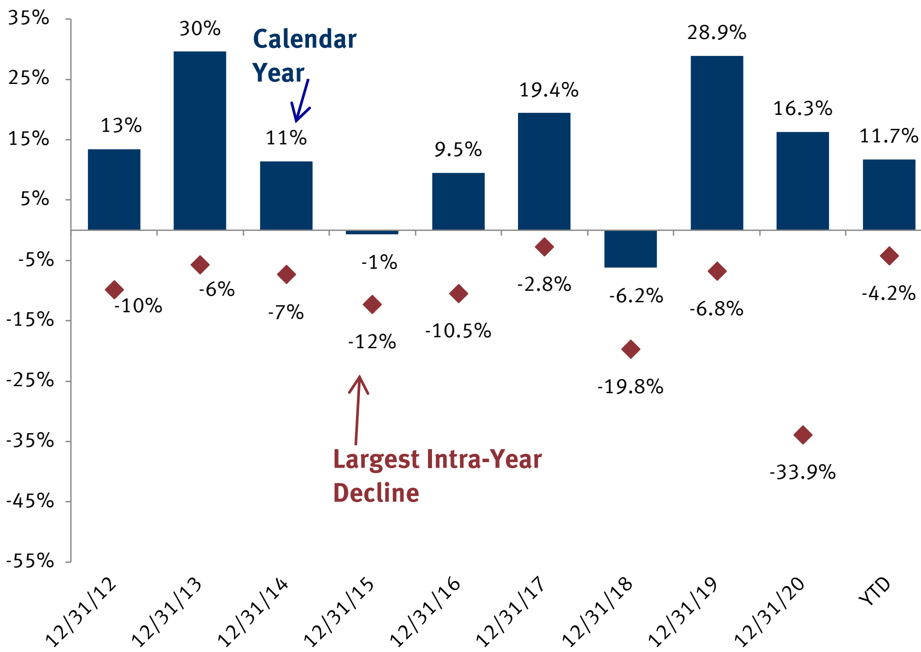
Exhibit 1. S&P 500 Index

Source: Stifel Investment Strategy via Bloomberg, as of May 26, 2021.

Last week we discussed the positive first quarter "earnings season," but despite these good results, stock market volatility has picked up recently.The S&P 500 is within 0.8% from its all-time high and has traded in a narrow range over the last six weeks. This begs the question, are stocks at risk of a pullback, a correction, or even a bear market? In this week's Sight|Lines, we review some risks to these elevated markets and discuss what to expect over the short, medium, and longer term.

Historical Context

Exhibit 2. S&P 500 Calendar Year Price Returns and Intra-Year Declines



Source: Stifel Investment Strategy via Bloomberg and Strategas Research Partners, as of May 26, 2021.

Figure 2 presents the annual return of the S&P 500 going back 8 years. We observe the known pattern of stock returns, that on average, the return has been positive. For this discussion, though, a helpful measure is the second data series presented, the intra-year declines each year, which average -11.4%. This reminds us that even during some of the most positive years for equity market returns, the market tends to fall meaningfully at some point during the year. So, it would be common for the stock market to decline further during the remainder of the year, yet end the year with a healthy, positive calendar-year return.

Near-Term Risks

So, what has investors nervous? We've discussed many such topics through the year, and they include the potential for a coronavirus variant resistant to vaccines, a slowdown in vaccinations to the point of risking herd immunity, and more recently, the prospect of higher inflation. There's also the risk that market valuations have "discounted" or "priced in" the recovery or more federal support than what actually plays out. For example, the Biden administration announced plans for two infrastructure packages totaling $3.8 trillion, but there's a good chance the final package will be much smaller. Finally, if interest rates rise, either driven by inflation or the result of higher real yields, stocks may well decline.

Confidence Is Key

Consumer and business confidence is key to economic recovery, earnings growth, and support for equity valuations. So, what data are we seeing on this topic? Well, first, business confidence is up, as reflected in the Markit composite purchasing managers' index (PMI). The latest reading of 68.1 is a record and well above the neutral reading of 50. So business leaders are signaling continued expansion.

On the consumer side, the Conference Board Consumer Confidence Index remained steady in May, after an increase in April. The Present Situation Index, an assessment of current conditions, increased. But the Expectations Index, reflective of consumers' short-term outlook, fell over the month. And, on a related note, retail sales are up 51.2% over the last year, signaling the consumer is confident to be spending.

Let's consider some results from *Stifel Proprietary Consumer Spending Survey*.

- Early in the year, only 56% of respondents indicated they planned to get vaccinated, with 24% undecided and the remaining 20% signaling plans to not get vaccinated. These figures have shifted as vaccinations have become more readily available and understood. In early May, 76% of respondents signaled plans to get vaccinated, 10% are undecided, and now only 14% say they won't get vaccinated. A helpful shift toward herd immunity.
- The survey results indicate that people are increasingly comfortable engaging in the economy, like flying and eating at restaurants. For example, 40% indicate they are comfortable flying now. So, good but still room for improvement.
- Finally, the survey indicates that recipients of stimulus checks planned to spend about 30% of all three payments on consumer staples, like gasoline, food, and household products. Discretionary spending has increased from 9% of the first check to 22% of the third check. This spending supports the economic recovery.

Back to Long-term Fundamentals

A review of the stimulus checks reminds us of the historic monetary and fiscal support provided in 2020 and 2021. Increasingly, investors are aware of just how helpful this support has been to the economic and earnings recovery. And with that awareness, we begin to ask the question: How will the economy and company earnings do when the effects of this historic support subside? We believe we will see above-trend growth in the economy and earnings into 2022. But investors and other market participants are forward looking, so the analysis is shifting toward the results that may be achieved in 2023 and beyond. And, while there is a generally positive view looking forward, our analysis will be focused on fundamentals, and if companies, consumers, and the economy can stand on their own. Related worries can trigger market volatility.

Conclusion

Stock market volatility is a natural thing, and investors should expect a pullback in each calendar year. The markets have been sustained by historic fiscal and monetary support and increasing confidence as vaccinations proceed and the economy reopens. Risks like higher inflation, troublesome variants, and the shift back to fundamentals are present in the current environment. We'll be mindful of these risks as our work unfolds going forward.

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