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WEEKLY ECONOMIC COMMENTARY

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Sliding into Summer: Stocks at Risk for Seasonal Correction

The stock market got a nice tailwind from calendar 1Q17 earnings season, recording 14% EPS growth that was the best in seven years. Stocks reacted so well to earnings season, in fact, that investors are again sounding alarms about valuations. Even if stocks valuations were not elevated, we would be skittish given the time of the year; June and July have lately been associated with mid-single-digit stock market corrections.

HAIR TRIGGERS

Recent jitters around a pair of high flyers – AAPL and NVDA – sent technology stocks to a two-day rout on 6/9/17 and 6/12/17. Apple was hit by two brokerage downgrades after it became evident that the next-generation iPhone would not be equipped with a mobile modem enabling 1 gigabit speed, as phones from Samsung and others will be. Apple acquires mobile modems (also called basebands, for connecting phones to the network) from two vendors. While Qualcomm has a 1 gigabit chip ready to go, Intel won't have its part ready by fall 2017, when Apple releases its 10th anniversary iPhone. Given that Qualcomm and Apple are locked in a bitter royalty-rate battle, Apple won't go the single-source route and will instead settle for a slightly slower phone.

NVidia's sin was simply being too hot. The stock was in the low $30s in May 2016 when the market woke up to the fact that graphics processing is much more efficient and powerful than CPU processing for modern data center tasks including machine learning and artificial intelligence. After NVDA ripped from $102 to an intraday $166 in a single month, valuation-based downgrades sent the stock to the $140s before it found temporary stability in the low $150s.

IN THE SUMMERTIME

Selling in the tech sector also triggered the Nasdaq's worst two-day stretch of the year. That tumble got investors worried that if it takes just two stocks to stagger the Nasdaq, the stock market's latest advance overall may be fragile.

Although stocks have pushed up to and (in some cases) past fair value, the broad market does not look dangerously overpriced. About half of the year-to-date gain in the tech sector, for example, is concentrated in just five stocks. In technology as in other sectors, there are plenty of high-quality names that have not fully participated in the advance.

Even if stocks were not showing a certain amount of skittishness, the calendar bears watching this time of year. We have documented that June through September represent a kind of dead-money period for stocks. Since 1980 on the S&P 500, average cumulative capital appreciation for the four months is a scant 0.9%. We count at least four individual months that have averaged better capital appreciation than that since 1980.

Perhaps in sympathy with the raucous thunder and lightning that sometimes cap sweltering summer evenings, June and July have become known for their stock storms. Since 1980, average cumulative capital appreciation for June and July is 0.9% (matching the June-September tally, as okay Augusts cancel generally down Septembers). Roughly a point of gains for two months is not great, but it is not out of line with a handful of other months.

Since the turn of the millennium, however, June-July have featured some nasty crashes. The two months delivered a 14.6% decline in 2002, at the tail end of the internet implosion, and a 5% drop in 2007, prefiguring the great recession.

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The 4% decline in June-July 2011 is deceptive, given that much of the summer 2011 crash was concentrated in early August. From peak to trough, the S&P 500 declined about 18% in summer 2011 and missed ending the bull market by a bear's whisker.

Summer selloffs just for the past four years are instructional. In 2013, the S&P 500 reached 1,669 on 5/21/13, only to fall 5.4%, to 1,579, by 6/24/13. Weakness may have been related to the "taper tantrum," after the Fed in May announced plans to begin reducing its monthly asset purchases. The resulting greenback strength and domestic bond-market retreat sparked selling in emerging market currencies, causing stock investors to temporarily move to the sidelines.

In 2014, the pullback came a little later, as the index peaked at 1,988 on 7/24/14 before dropping 4.0% to 1,909 by 8/7/14. Once again, concerns about potential Fed policy played a role, as investors began to predict timing of a potential first rate hike. Stocks also reacted to deflation fears in still-stagnant Europe and Argentina's debt default. Two months later, oil would hit peak prices before beginning a one-and-a-half year slide.

In 2015, the S&P 500 fell 3.5% from 2,130 on 5/21/15 to 2,057 by 7/9/15. Then on 8/24/15, the DJIA suffered its worst one-day drop since 2011, shedding 588 points after declining 1,000 points intraday. The proximate trigger was a dip in NYMEX crude below $40, making investors wonder if oil would find a floor anytime soon. Continued strengthening in the U.S. dollar pushed down commodity prices and investors' nerves past their breaking point.

The oil swoon/dollar spike culminated in January-February 2016, when NYMEX crude reached $27 per barrel. The S&P 500 by early February was down 10% year to date. But stocks bounced back as oil and commodities finally stabilized and the dollar began to back off. By early June, all was right and the markets sailed blithely into the Brexit vote, only to confront the first in a series of populist shocks. The S&P 500 reached an interim peak at 2,113 on 6/23/16, only to dive to 2,054 (down 5.1%) just four days later on 6/27/16.

NEVER SAW IT COMING

Examining the origins of each of the past four summer selloffs, we see four different triggers: the taper tantrum, deflation fears, commodity price & dollar fears, and the populist wave. The common element each time was a reassurance by economists that what happened last summer won't happen again. And those economists were right: in each case, the market was sandbagged by a fresh crisis.

Investors should react skeptically to arguments that that the current rally is intact and even summer-proof because earnings are growing and any asset bubbles are moderate to non-existent. These and other such reassurances will blow away like summer dandelions once the next unforeseen event hits.

Between 2013 and 2016, the four summer corrections (not including the flash crash of 8/24/15) averaged 4.5%. The cause of each correction was unique, leading to new anxieties. As gut-wrenching as those selloffs were, however, each was followed by rallies to new highs, occurring (except in 2015) within a month or two of the summer lows.

CONCLUSION

Just as investors never saw it coming over the preceding four summers, we won't clearly see the trigger for this summer's selloff until it is upon us. While admittedly dealing with our own anxious moments, we will try to keep our cool as other investors wig out by repeating the mantra: corrections are good for the bull market.

Corrections shake up the unhealthy status quo that occurs in markets reliant on lazy beta. Corrections sink the leaky vessels that have been rising on the lift-all-boats tide of a thoughtlessly rising stock market. Corrections push cash to the sidelines, where that cash sits as a reservoir to fuel the next leg of advance when investors get bullish again – as they almost always do.

Like most summer thunderstorms, summer corrections tend to result in minimal lasting damage. Corrections that occur amid still-strong market and economic fundamentals create opportunities, in our view. If or when this summer's correction hits, we would use weakness to buy recently out-of-reach blue chips that have been knocked back to more attractive valuations.

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