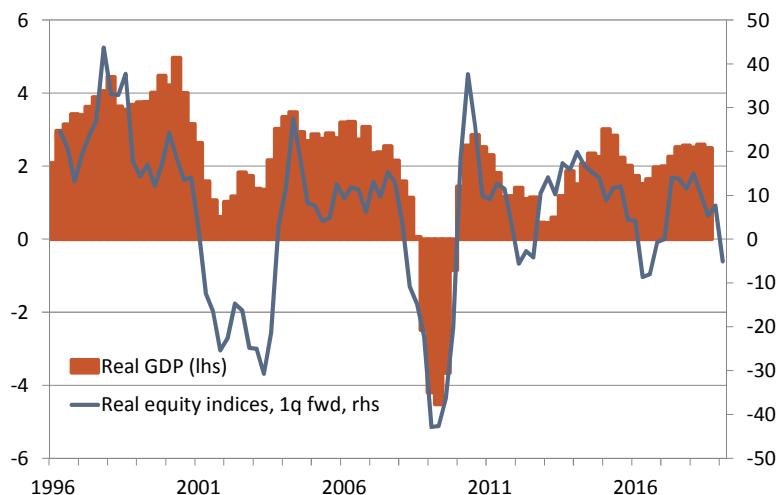


22 November 2018

How serious is the stock market correction?

Yoy changes in equity prices and real GDP in the western world: not too bad yet



Weighted average of S&P 500 and Eurostoxx 600; deflated with GDP deflator, advanced by one quarter, right-hand side; weighted average of US and eurozone real GDP, yoy changes in %. 21 November as proxy for Q4 2018. Sources: Bloomberg, Haver Analytics, Berenberg calculations.

- Every major stock market correction raises questions:** Will consumers spend less and companies cut investments? Will the economy go into recession? How will policymakers respond? The recent correction and sizable fall in tech stocks elicit memories of the 2000 stock market collapse. 18 years ago, the bursting of the dot.com bubble heralded a mild recession. While we see some parallels with the current situation, the differences are much larger.
- Some parallels:** In both cases, equity markets corrected after almost a decade of sustained economic growth and stock market appreciation in the US. Stock markets began collapsing in March 2000, with the US S&P 500 dropping by 20% and the NASDAQ falling by 60% even before the terror attacks of 11 September 2001. The S&P 500 is currently down 10% from its September peak and the NASDAQ is down 14%.
- Differences between 2000 and now:** The capital spending boom of the 1990s had resulted in excess capital stock relative to GDP, at least in the US. Through most of the current expansion, business investment has been modest. As the US capital stock is in line with GDP, and Europe is still behind on investment, a major correction in capital spending is not required. On both sides of the Atlantic, solid labour markets support private consumption. US consumers still benefit from the Tax Cuts and Jobs Act. However, corporate debt is higher.
- Valuations matter:** The dot.com bubble was characterised by a lack of revenues and profits at high-flying companies; price/earnings ratios on the S&P500 exceeded 27 in early 2000 (and were astronomical on the NASDAQ). Presently, the top tech companies are generating huge revenues and profits while holding sizable cash balances. They are key components of the US economy, with sizable global imprints. S&P500 price/earnings ratios were sub-20 prior to this recent correction.
- Mind the Fed:** Monetary policy was tight in 2000. The Fed had raised the funds rate to 6.5% (+4.0% in real terms) and inverted the US yield curve. US monetary policy currently remains accommodative by standard measures, with the real Fed funds rate slightly above zero and a massive Fed balance sheet. Financial conditions are still easy. In 2000, the combination of excess investment and a tight monetary policy had laid the basis for a mild recession. This time, economic fundamentals do not signal a need for such a cleansing.
- Economic impact:** We expect the US economy to continue to grow at a still solid but slower pace in 2019. The two biggest US risks centre on confidence and China. A sharp decline in the currently high levels of confidence would constrain consumer spending and business investment. If China's growth continues to moderate, slower gains in global trade volumes would restrain global growth. However, China still has the means to inject more stimulus, if required. While the eurozone economy would be particularly vulnerable to a sizable slowdown in China, it stands to gain more from less elevated oil prices. Unlike the US, the eurozone is not a major oil producer itself.
- The policy response:** We expect the Fed to proceed with its December rate hike, but to pause no later than mid-2019 and possibly earlier than that, and the ECB to end asset purchases, but send a dovish signal in December.

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