Baird Market and Investment Strategy

Breaking News: Stock Market Update

October 24, 2018

BAIRD

Please refer to Appendix – Important Disclosures.

Stock Market Update – Wednesday, October 24, 2018

The October correction and explosion in volatility gained momentum today with the break of 2700 on the S&P 500 Index. The current decline is more a function of a weakening technical position as opposed to the fundamentals breaking down. The technical picture includes, of course, investor psychology that has experienced widespread and deeply seated complacency. For most of the current decline, investors have been too quick to signal a bottom but that appears to have changed today with panic-like selling in most of the heretofore strong groups and sectors. We view the selling today as a mild positive as it represents a change in sentiment and a first step in identifying a market low. Under the surface, the problem persists with the broad market continuing to underperform. This was the primary reason for our cautious approach this summer despite the new highs in the averages. The broad weakness is best seen in the Russell 2000 Index and the NYSE Composite which are hitting new lows for the cycle. We would look for these indices to bottom before the market is set to reverse.

The economic fundamentals remain favorable with most of the leading indicators and today's PMI data showing growth continuing at a good pace. Third-quarter earnings have been better than expected but were likely already built into current prices. But given the strength in the labor markets and confidence levels among small business at record levels, the odds of a business turndown in the U.S. is unlikely. As a result, we remain bullish on the U.S. economy.

The largest problem for stocks is that the downside momentum is so pervasive and that until that is broken investors should wait for an all-clear signal to enter. Once the downside becomes exhausted, we need to confirm that the decline has run its course. This is accomplished by monitoring the daily volume data. If stocks are poised to reverse and head higher into year-end, we need to see at least one session where upside volume exceeds downside volume by a ratio of 10-to-1 or more. Given that there has been seven sessions where downside momentum has overwhelmed, this year we may need to see two days of a surge in upside volume.

Bottom Line: Downside momentum needs to be broken before looking for stocks to rebound into year-end. Given today's severe selling it seems likely that stocks will test the February lows near 2600 using the S&P 500.

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