March Madness: Market Correction or Looming Bear Market?

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It has been an unsettling few weeks for investors with the S&P 500 posting the 5th fastest market correction of 10% from the 52-week high since 1950. Even the Magnificent 7 stocks, the most crowded trade on earth, entered bear market territory with a decline of 20% from the record high in December. What started as a re-pricing of growth stocks with lofty valuations is now morphing into a downgrade of economic growth and corporate earnings expectations driven by disruptions in AI, DOGE related job cuts and relentless headlines about tariffs. The resulting angst has caused many investors to speculate that the U.S. economy is headed for a recession. While the elevated level of policy risk and uncertainty has raised the probability of a recession, some of the most trusted leading indicators point to a much higher likelihood of a market correction that does not reach bear market territory.

To this point, the tariff related "tape bombs' have caught some investors wrong-footed that were expecting more focus on pro-growth initiatives and less regulation. Treasury Secretary Scott Bessent is a Wall Street veteran and is becoming an important voice on the goals of the administration. He recently stated that they are trying to rebalance the economy and that "the market and the economy have just become addicted to this government spending, and there's going to be a detox period." Given that the economy has entered a period of transition, these are objective points to consider: U.S. growth is slowing, U.S. fiscal dominance must recalibrate lower, and no investor actually knows how the economic transition and tariff polices will evolve.

As a result, the heightened level of policy uncertainty from Washington is at least temporarily creating a wait-and-see economy. Therein perhaps lies the biggest risk to markets in that today's negative sentiment evolves into a reduced level of consumer spending and rising unemployment, which could then lead to a recession. Case in point, Delta Airlines disclosed last week a nearly 50% cut in their quarter earnings forecast from their previous estimate in December. Delta commented in a filing that "the outlook has been impacted by the recent reductions in consumer and corporate confidence caused by macro uncertainty, driving softness in demand."

In what seems like a distant memory, the S&P 500 had just set a record high on February 19th near the end of fourth quarter reporting season which showed sales and earnings exceeded expectations with gains of 5% and 13%, respectively. S&P 500 earnings growth has been revised lower over the past few weeks from 14% to 11.5%, according to FactSet. Collectively, the balance sheets for the companies in the S&P 500 are comparatively strong, and likely to be resilient during an economic slowdown.

It is also worth noting that the increasing trend of passive investments has led to less liquidity in the stock market, which more recently exacerbated moves in both directions. For example, several large multi-strategy hedge funds were forced to collectively liquidate billions in crowded trades last week, which added to the downside pressure on the market. This type of rapid liquidation was last seen in August of last year when the S&P 500 declined 6.1% in just three days.

In my view, the credit markets are the best arbiter for differentiating a common market correction from a bear market. Aside from an exogenous shock to the economy, most recessions have historically stemmed from problems in the credit markets. At this point, the broader credit markets are reflecting a revision to slower corporate earnings growth, but not contraction.

In past cycles, the high yield bond market was considered the canary in the coal mine for the first sign of trouble in the credit markets. The companies in this market have fragile balance sheets and would typically be among the first companies to face default. The bonds in this market can quickly become illiquid during a credit crunch, so investors will prioritize reducing exposure during signs of economic weakness. However, the overall credit quality of the high yield companies today is much better than it was 7 years ago, as many of the weaker companies have moved to the private credit markets. That said the lowest-rated CCC bonds in high yield saw their credit spreads start to widen notable last week. It will be very important to see if the weakness in the lowest-rated bonds spreads to the higher-rated bonds.

The new canary in the coal mine to watch for recession is in parts of the private credit markets. This asset class has grown very quickly to about $1.5 trillion, which is nearly the same size as the high yield market. Private credit is an unregulated and opaque asset class with limited liquidity and does not feature mark-to-market pricing. This space of the market has not been tested in a deep recession and could dwarf the lack of liquidity seen in high yield during previous recessions. Currently, signs of distress are just starting to appear, and at a level that is somewhat more concerning than witnessed in CCC bonds.

Bottom line, it is too early to know from a government policy perspective or signals in the credit markets if the economy is in the more common corrective phase or headed for a recession. It is also worth noting that the additional fiscal spending policies in Europe and China are likely to have a positive impact on global growth and asset prices. As we await further evidence, it is worth noting that making portfolio changes in anticipation of a correction in the market can be hazardous to your wealth. Legendary investor Peter Lynch once said that "far more money has than has been lost in the corrections themselves." It is therefore critically important to have an investment process that can help distinguish the probabilities of a correction versus bear market and avoid investment choices based on emotion.

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