

Research Briefing | Global

Equity correction risk rising after recent ‘melt-up’

Economist

Adam Slater
Lead Economist
+44(0)1865268934

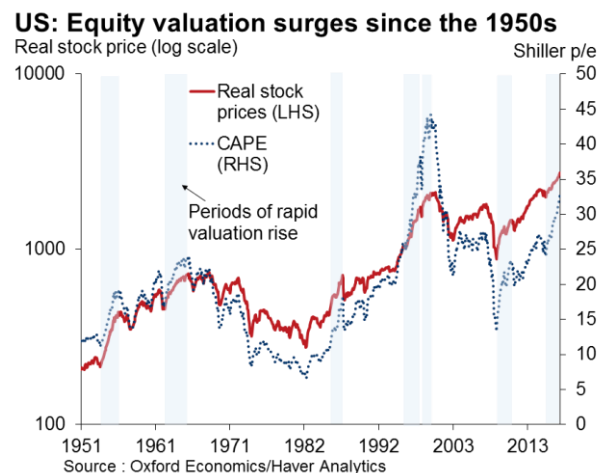
Equities have surged further since last August – raising the risk of a significant correction

Chart 1

Six previous valuation surges have been followed by ultimate corrections averaging 25%

- Equity prices have surged from already-high levels last August, with valuations scaling even loftier heights. Our analysis, based on historical evidence, suggests short-term risks are broadly balanced between a downward correction and a further ‘melt-up’ rally. But the latter would risk an ultimate correction in stocks of well over 10%.
- The Oxford Global Economic Model suggests a 10% change in stock prices alters the level of GDP in the G7 countries by around 0.3% on average after two years. A 25% equity correction would potentially cut US growth to around 1% by 2019. The risk of such a damaging stock price slump could prompt early Fed action to restrain markets, if valuations continue to stretch.

Last August, [we noted](#) the risk of a significant correction in equities. Since then, the equity rally has continued to gather pace – US equities have risen a further 14%, with a 5% rise just since the start of this year. This has taken valuations to even loftier heights. On all major long-term measures, US stock valuations are at levels last seen during the late 1990s dotcom boom.



US stocks have surged a further 14% since last August, with a 5% rise in January alone, hoisting valuations further - from already high levels. Six previous surges in valuations of this kind were all eventually followed by large corrections, averaging 25%.

CAPE=cyclically adjusted price/earnings ratio

The surge in equity prices and valuations since last August, from already high levels – which we [dubbed](#) a ‘melt up’ earlier this month – would appear to increase yet further the risk of a significant correction. We identify 46 corrections of 10% or more in US stocks since 1946, averaging about one every 18 months. The current run of equity gains since the last such correction (at the turn of 2016) is 23 months.

We have also found six previous periods where the cyclically adjusted price/earnings ratio (CAPE) rose by a similar amount (around 7ppt) and over a similar period (initially two years) to that seen since early 2016, without a correction of 10% or more. All these episodes were eventually followed by large corrections, averaging 25%.

Contact: Adam Slater | aslater@oxfordeconomics.com

But valuations are not good predictors of short-term equity dynamics: the upswing could still extend further

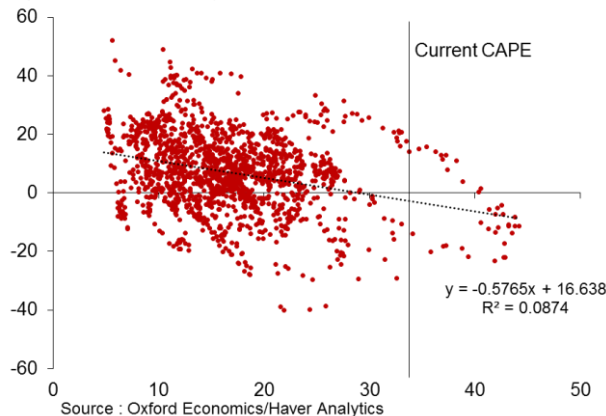
However, such a large correction is not necessarily around the corner. First, a number of the ‘melt up’ episodes were temporarily halted by more modest corrections only to give way to a new period of gains: this was so in the mid-1960s and in the dotcom bubble of 1997-1999 (punctured by two significant setbacks in mid-1998 and mid-1999).

Second, while valuations provide a good steer for long-term stock returns, they don’t predict short-term stock returns so well. If we look at the spread of historical two-year returns when valuations have been around current levels we see a bi-modal pattern with very high positive or very high negative returns possible – and not much in between.

Chart 2

US: 2-year stock returns and Shiller CAPE

2 year real total returns, per annum



While valuation measures predict long-term stock returns quite well (e.g. over 10 years), they don’t predict those over two years so well. Historically, when US valuations have been around current levels, two-year returns have either been very high or very low – with little in between.

The Fed might act early if valuations soared further to head off stability risks

So a further significant rise in equity prices can’t be ruled out, and the currently benign macro environment adds to that risk. But that would push valuations to extreme levels and would risk early intervention by the US Fed – even though the Fed has generally given equities a strong weight in decision making [only when they have been slumping](#).

The Oxford Global Economic Model suggests that a 10% change in equity prices alters the level of GDP in the G7 economies (on average) by 0.3% two years on. The impact is bigger in the equity-heavy US, at 0.5%. So a 10% further rise in stocks could push US growth above 3% this year – and unemployment down to just 3.7% (a near-50 year low).

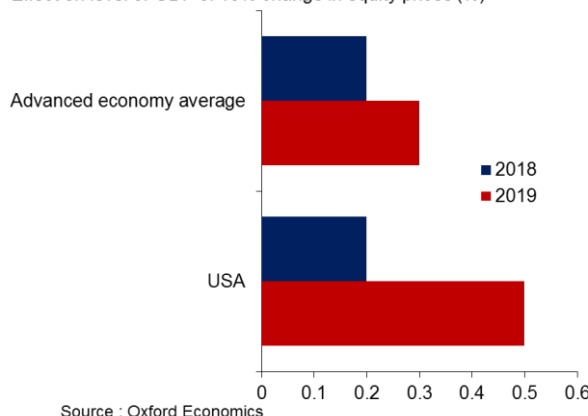
A 25% equity correction could see US growth slump to around 1% by 2019

Those kinds of macro numbers alone might lead to early Fed action to restrain stocks. But perhaps more important would be the risks to macroeconomic and financial stability of allowing equity valuations like the CAPE to drift towards all-time highs. This can again be demonstrated by model simulations – a global 25% decline in stocks as seen after previous valuation surges would imply US growth slumping to around 1% in 2019, with serious potential consequences for credit markets, defaults and bank balance sheets.

Chart 3

Modelled impact of equity price changes

Effect on level of GDP of 10% change in equity prices (%)



The Oxford Global Economic Model suggests a 10% change in equity prices has a 0.3% impact on advanced economies’ GDP, on average, by the second year of a simulation with a 0.5% effect in the US (these include the impact of varying monetary policy). The simulation was run over 6 quarters from Q1 2018 onwards.