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MARKET STRATEGY VIEWPOINT

Newfound Equity Price Pressure

October 26, 2018

Risk-based assets endure the first material price correction since February. Global equities, commodities, and high-yield bonds come under notable pressure.

Fed Policy, Interest Rates, Global Trade In Focus

Broad equity benchmarks and other risky asset classes have come under sustained price pressure over the last few weeks. The period has also included noteworthy days of 2%-3% price drops in the major equity averages, and those instances have captured the attention of more than just the financial media. Since the price pressure contrasts mightily with the relatively smooth equity ride we have witnessed over the last two years, few have failed to notice the market developments. And the activity has also carried over to credit markets, commodities, and various derivative prices.

Major Asset Classes - October MTD	Index Value	Period Total Return	52-Week Index High
S&P 500 Index	2,705.57	-7.06%	2,930.75
MSCI All Country World Index	477.29	-8.88%	550.32
MSCI EAFE Index	1,797.61	-8.85%	2,186.65
MSCI Emerging Markets Index	953.05	-8.99%	1,273.07
Bloomberg Barclays U.S. Aggregate Bond Index	2,002.69	-0.55%	2,048.67
Bloomberg Barclays U.S. Corporate High-Yield Index	1,975.77	-1.21%	2,004.71
Bloomberg Commodities Index	84.62	-0.51%	91.57

Note: MSCI and Bloomberg Barclays "Index Value" and "Period Total Return" as of 10/24

S&P 500 and Bloomberg Commodity Index values as of 10/25

There were multiple catalysts for the recent market response; including some concern that the Federal Reserve may tighten (raise rates) too fast. The uptick in markets interest rates over the last few weeks points to that worry, although the equity volatility and safe-haven Treasury bond demand have caused yields to recede most recently. Meanwhile, seemingly constant concern over trade relations with China has been cited as a variable that may have at least temporarily helped tip the near-term balance in equity markets. The fact that China issued a worse-than-expected GDP figure for Q3 (6.5% reported on Oct 18) has weighed as well. Finally, the approach of U.S. elections and what the results may mean for government policy has also added an element of anxiety.

While many participants have pointed directly at the fundamental issues named as a reason for the sell-off, we also believe some reversion-to-the-mean in equity markets has been a cause for some of the recent trading. Simply, prices of equities and other financial assets have proceeded higher,

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Equity market volatility has been unusually low over the last two years.

nearly unimpaired, for much of the last two years. Using history as a guide, this is unusual activity. Typically, equity markets may endure two or more 5%-10% price drawdowns within a given year, however, investors have been largely spared that circumstance since 2015. With history in mind, we believe financial markets were in fact overdue for some asset price correction.

Some Operating and Seasonal Positives Ahead

Looking ahead, investors should remain somewhat cautious with their allocations over the coming quarters. Expectations for an overdue drawdown and a business cycle upswing that may be reaching the latter innings are key to this recommendation. However, we are not expecting the October drawdown to lengthen materially through the last two months of this year. Volatility is likely to be somewhat higher than we are used to, but seasonal factors and the return of corporate buybacks could help support equity prices.

In November and December, equity markets have been historically positive

Looking back, the S&P 500 Index has closed down only 3 times in the last 15 years during the months of November or December. In addition, some market relief could be in the outlook following Election Tuesday, and an expected strong holiday retail selling season may help stocks rally a bit through December. Meanwhile, the resumption of corporate equity buybacks (corporations, by law, are relegated to a blackout period during earnings season) may also add a bid to this market.

Core bonds typically serve as an important buffer against equity market risk.

The message here is that while we believe some equity market relief may be on the way, investors will want to stay vigilant and maintain a well-balanced, multi-asset portfolio. In our view, equity returns overall may prove to be less robust in the coming quarters versus what we have seen over the last two years. Importantly, healthy core bond allocations should provide some shield against any future equity volatility.

Risks

Investors should be aware of the risks associated with all portfolio strategies, and variable market conditions. Monetary policy changes, military activity abroad, the level and change in market interest rates, corporate earnings, domestic and foreign governmental policies, global economic data, and other geopolitical events can have a substantial effect on portfolio performance, our macroeconomic theories, and the effectiveness of strategic and tactical portfolio approaches.

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