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Tightening Credit to Accelerate Volatility

Since the S&P 500 peaked at 2,940 in late September, the index has retraced approximately 6.5% in recent days, erasing most of the year-to-date gains from the best performing global equity market. While the headline decline is modest, many underlying stocks and sectors (i.e. technology, and small cap growth) have corrected closer to the 10% level. The recent selloff has been felt across all geographies, further widening the disparity between the best (S&P + 3%) and worst (China Shanghai -20%) performing equity markets year-to-date. In hindsight there are always a list of factors that investors can highlight as the catalyst for risk-off sentiment, but in this recent episode we would point to rising credit yields and a general tightening of financial conditions as the main culprits – not unusual in the later years of an equity bull market when volatility typically accelerates.

Due to rising yields we are in a rare moment when neither sovereign nor corporate credit serve as a safe-haven investment for financial assets, unusual behavior given the typical inverse relationship between equity risk and credit yields. The increased correlation of stock and bond price movements are more prone to occur in the later stages of a bull market, <u>but typically does not persist for long</u>. We are in the middle of the Fed's playbook and economic bottlenecks are pushing costs higher, the culmination of which finally untethered the yield curve pushing rates materially higher. The yield of the 10-year US Treasury Bond has not been above 3% since 2011! The rise in yields is a reminder that we are in the middle of a tightening cycle, and although fiscal policy (via tax reform) has been driving recent investor optimism, the two contrasting policies will result in increased volatility in the year ahead. Investors should not lose sight of the reason why the Fed is lifting rates; the US economy is very strong, both led by a healthy consumer and corporate backdrop which is a positive for equities. A 3% level for the 10-year US Treasury Yield is reasonable given where we are in the cycle.

Because we expect volatility to remain above the levels experienced in recent years, we encourage investors to revisit their asset allocation and consider the shifting opportunities available today. For example, for the first time in over a decade cash is becoming increasingly attractive for investors. The ability to earn between 2 and 3% in a "near" risk-free investment when forward equity market returns are estimated by many to be in the mid-single-digit range should be compelling. We also highlight that equity returns have been lopsided in recent years. For example, the Russell 1000 Growth index has outperformed its value counterpart by 5.2% annualized over the past 5 years, resulting in a valuation disconnect between the two styles. Investors should consider this an opportunity to rotate to more attractive pockets of the US equity market. Lastly, emerging markets have been a significant underperformer this year, declining 16% through October 11th, and lowering the 5-year trailing annualized return to a paltry 1.4%! For investors with a long time horizon, we will likely look back on 2018 as an attractive entry point for emerging market equities.

The opportunity set for investors has rebalanced in recent weeks, not only increasing the importance of fixed income to a diversified portfolio through higher yields, but also reminding investors that equity rebalancing is critical to attractive, long-term, risk-adjusted returns. We continue to believe broad equities offer the highest forward return across asset classes, albeit at a slightly lower rate than a few years ago with higher volatility. The fundamental environment remains constructive as the US economy continues to expand, and corporate profits should still rise in 2019, but at a much lower growth rate than experienced in 2018. We do not believe a recession is imminent in the near-term, despite some of the doom and gloom perpetuated by popular media and the attention a flattening yield curve has received. Looking abroad, global growth is expected to be in the high 3% range this year, and should support financial assets in the near-term, especially when combined with continued earnings growth and undemanding valuations in Europe and Asia. With higher yields available and equity volatility expected to accelerate, now is the time to rebalance your investment portfolio to maximize the risk-adjusted return for the next few years of the economic cycle.

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