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Market Sell-off—What Investors Need to Know Now

Global Investment Strategy Team

Key takeaways

» *A swift climb in the 10-year Treasury yield and a strong employment report contributed to Friday's equity market pullback.*

» *Solid fundamentals have been driving the rally, but volatility risks are rising. We believe the path for equity markets this year is still higher but may not be as smooth as it was last year.*

What it may mean for investors

» *Our outlook is for continued strong global economic growth, and equity fundamentals appear positive. A disciplined plan to allocate cash at regular intervals or on market pullbacks should help investors reallocate to those sectors and asset classes where we see value.*

We have been expecting interest rates to move somewhat higher and equity markets to pull back following a significant increase over the past 12 months. Market participants are worried about the transition in leadership at the Federal Reserve (Fed) and the recent reset in market interest rates. The 10-year Treasury yield has risen by 40 basis points over the past month.[1]

On Friday, the Dow Jones Industrial Average (Dow) fell 2.5% and dropped by 666 points. For the week, the S&P 500 Index was down nearly 4%, and Energy was the worst-performing sector, with a 6.5% decline. Weaker-than-expected earnings for a few companies and higher interest rates led to the worst weekly decline since January 2016. And, yet, the Dow is still up more than 3% year-to-date, and the index has returned over 28% in the past 12 months.

Our view is that the global economy is strong and the fundamentals remain positive. We believe that investors should keep a longer-term perspective and remain fully invested in a diversified portfolio that is allocated according to their risk appetite and time horizon. We continue to favor U.S. stocks relative to international stocks and expect domestic companies to benefit from solid economic conditions and fiscal stimulus as the year progresses.

[1] One hundred basis points equal 1%.

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Why did stocks sell off last week?

The first thing investors need to do is put last week's correction into the proper perspective. From November 15, 2017, through January 26, 2018, the S&P 500 Index rose 12%. This nearly vertical move higher couldn't last forever. The last time the S&P 500 Index had a 3% daily drawdown was on November 1, 2016; the last time the index lost more than 3% in a day was the 3.6% drop on June 24, 2016, the day after Great Britain's referendum on leaving the European Union. It is helpful to remember that, on average, the S&P 500 Index has had a 10% pullback approximately every 11 months since 1928. We have not had a 10% pullback in that index since late 2015 and early 2016. We believe that the market has been due for (at least) a consolidation. Based on Friday's close, the S&P 500 Index is down less than 4% from the all-time record high set in late January. At this point, we would categorize this pullback as minor.

A swift climb in the 10-year Treasury yield and a stronger-than-expected employment report that showed wages up more than expected over the past 12 months also contributed to Friday's stock-market tumble. Since early 2017, we have noted that investors could become concerned if wage growth jumped and negatively impacted currently high corporate profit margins. Compensation is frequently the largest expense item for most corporations.

What are the equity-market implications if the Fed hikes rates three times? Four?

We believe that the stock market has been slow to come to grips with the likelihood that the Fed and other major central banks around the world will be reducing the level of stimulus they are providing to their economies over the course of this year (and likely next year as well). Fed funds futures contracts have only recently priced in the possibility that the Fed would hike rates three times this year. Our 2018 outlook has included the possible risk that, if equity investors come to believe that wage growth and inflation will accelerate and force much faster interest-rate hikes, equity markets could see more volatility than they did in 2017.

Fed rate-hiking cycles are almost always a headwind for equity-market valuations. Price-to-earnings ratios in past hiking cycles have contracted anywhere from 15% to 35% from top to bottom. Stocks are currently not cheap, and some investors are becoming concerned that the Fed will boost rates too rapidly, given the level of gross domestic product (GDP) growth that is expected. This has been a common mistake by our monetary authorities in past economic cycles. To be sure, it is not easy to fine tune a $20 trillion economy under any circumstances. Yet, it is particularly so in the aftermath of unprecedented central-bank policies that were intended to reflate the global economy in the wake of the financial crisis.

Do we see new opportunities in sectors that could result from this sell-off?

We continue to believe that investors should overweight the Industrials, Consumer Discretionary and Financial sectors. These sectors are sensitive to the ebb and flow of the economy and should continue to benefit from the ongoing expansion we envision.

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Note that these three sectors also pay some of the highest effective tax rates of the 11 sectors in the S&P 500 Index. They should benefit from the new tax code as well as improved economic growth and a tighter labor market. We also have an overweight position in the more defensive Health Care sector. We believe that investors should boost their exposure to these sectors on pullbacks if they are not currently overweight in their equity allocations. We also believe that investors should look at pullbacks as an opportunity to put sidelined funds to work.

Are fundamentals still solid for U.S. equity markets?

Several key factors contribute to the favorable fundamental backdrop. The improving economy and the tax overhaul should drive stronger domestic corporate revenue and earnings growth. We do not currently see the signs for recession in 2018. We expect inflation to trend mildly higher in 2018—consistent with moderately higher bond yields. This still is a benign factor for equity prices. Current exchange rates put the U.S. dollar in a weaker position than was the case a year ago, and this supports earnings for multinationals. Looking ahead, crosscurrents around the dollar should prevent strong depreciation or appreciation from today's levels, based on our current analysis.

Additionally, institutional investors, corporations, and households still hold significant cash positions that are available to support equity markets. Many retail investors have been meaningfully underexposed to stocks for much of this multi-year rally. Solid fundamentals have been driving the rally, but volatility risks are clearly rising. New highs are possible later this year, but we believe that the path higher is not likely to be as smooth as it was in 2017.

Yet, the market's fundamental outlook does not suggest a bubble. Although we have come off of a strong year for equity returns overall, fundamental factors do not suggest that domestic equity markets are currently in bubble territory. In fact, looking back to 1970, when the S&P 500 Index had increased by 18.5-22.5% over the course of a year (it is up roughly 22% over the past 12 months), the index has moved higher in the following year 75% of the time, with a median 12% increase. It has declined 25% of the time with a median decline of 10% over the next year. Out of the 40 instances, 2 of the 10 instances of forward 12-month declines were related to recessionary periods.

How are international markets responding to the downturn in the U.S. equity markets?

International equities may see some follow-through selling on Monday. Many international equity markets closed on Friday before the U.S. stock-market selling accelerated late in the afternoon. Emerging-market stocks have been the best performers so far in 2018, but they are likely to come under pressure from higher interest rates. So far, emerging-market equities have handled the Fed rate increases and slightly higher bond-market yields, but historically, increasing U.S. interest rates have put pressure on emerging-market equities.

Following last week's market weakness, we still favor domestic equities over international stocks.

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What should we make of the rise in U.S. Treasury security yields?

The bond market is reacting to improved economic data and a Fed that is becoming a bit more hawkish as a result. If U.S. economic growth remains in the current moderate trend, the rise in yields could be excessive and offer investors a buying opportunity.

Ten-year Treasury securities have increased by almost 40 basis points since the beginning of this year. While this move is meaningful, 10-year Treasury yields are only about 20 basis points higher than they were in March 2017. Sudden yield adjustments are not unusual in the fixed-income market. In fact, since 2009, there have been 10 months in which 10-year Treasury yields increased by at least 30 basis points. The lack of bond-market volatility in 2017 was unusual.

Is this move a sign of impending inflation problems?

Inflation pressures tend to increase when the economy improves at a faster rate than was anticipated. As a result, market-based measures of inflation expectations have been trending higher in recent months. Yet, it is worth noting that the level of inflation expectations remains below historical averages. Our 2018 outlook identifies inflation as a risk to our fixed income interest-rate expectations. The recent move in yields indicates that this risk has increased, but we do not believe that it is an impending problem.

Are we worried that our forecast for two Fed rate hikes is too low?

Market-based probabilities suggest that the likelihood of at least three Fed rate hikes in 2018 is now about 60%. The Fed appears willing to continue its recent pace of rate increases even as inflation remains below its stated target level. If these trends persist, we likely will need to raise our expectations for Fed rate hikes in 2018.

Does this move in rates change our advice on the yield curve and duration?

No. We are currently underweight the fixed-income asset group in portfolios, and we are evenweight (neutral) across the short-term, intermediate-term and long-term fixed income classes. We would not recommend increasing duration as a result of the recent bond market sell-off. The 10-year Treasury yield is within our expected year-end 2018 range of 2.50-3.00%. Should the sell-off persist and longer-term interest rates continue to move meaningfully higher, we likely would revisit our duration and positioning advice.

One positive in the most recent sell-off is that the yield curve has steepened. On January 15, 2018, the difference between the 10-year Treasury yield and the two-year Treasury yield stood at just 55 basis points. In recent trading, the differential has increased to 70 basis points. A steeper yield curve generally implies that the economic outlook is improving.

Do we see new opportunities in fixed-income sectors from this sell-off?

Most fixed-income sectors generally have been well behaved during the recent sell-off, and we do not see signs of undue stress in fixed income markets at this time. Higher yields and the ability to earn additional income may appeal to some conservative investors.

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The high-yield bond sector has declined in value as Treasury yields have increased, but credit spreads remain near their lowest levels for this cycle. We believe that investors should underweight the high-yield debt class.

What should investors do now?

We believe that this is an appropriate time for investors to:

- Maintain a modest cash position, but look for opportunities to become fully invested—Cash and cash alternatives have a place in an investment portfolio for rebalancing, tactical opportunities, and transaction costs. However, we believe the amount should be kept at a minimum as returns for this asset class historically have barely outpaced inflation and have lost ground to inflation more recently. For investors that are overweight cash, we recommend dollar cost averaging into a diversified mix of assets.
- Maintain exposure to fixed income—Even in this low-rate environment, we feel bonds (and other fixed-income holdings) should be included in a diversified portfolio. They can provide income, stability of principal and low correlation to equities.
- Globalize equities— U.S. equity markets have outperformed their international counterparts for much of this recovery. However, that trend was broken in 2017, and that development has carried over to 2018. International economies and earnings are improving, and as we have seen in the past, international equities do not always move in lockstep with U.S. equities. We believe investors should not be underexposed to these stock markets as they potentially hit their stride.
- Consider alternative investments—Hedge funds may provide some downside protection as equity markets decline in volatile periods. We expect hedge funds to generate positive returns in 2018 as correlations fall and the environment for active management improves.
- Stick to your plan by rebalancing—Letting a portfolio move with the markets without rebalancing can lead to portfolio risk that does not match an investor's risk profile. Keeping a portfolio aligned with its strategic allocation targets can reduce potential overexposure to risky assets when a correction or bear market arrives.

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Risk Considerations

Forecasts are not guaranteed and are subject to change.

A periodic investment plan such as dollar cost averaging does not assure a profit or protect against a loss in declining markets. Since such a strategy involves continuous investment, the investor should consider their ability to continue purchases through periods of low price levels.

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