October 1, 2019

What Happened in the Markets?

- US stocks had their largest pullback since August as the S&P 500 fell 1.2% to close at 2,940. All three of the major US averages dropped on the session, with the Dow Jones Industrial Average (-1.3%) leading the losses. Despite the negative return, the S&P remains only 2.8% below its July 26 all-time high.
- Economic concerns were evident on the first day of the fourth quarter after September's ISM Manufacturing survey came in at 47.8 versus the consensus forecast of 50.0. A level below 50 indicates a contractionary environment, while a number above signals expansion. Tuesday's print represents a new post-Financial Crisis low. The US data echoed similarly weak results out of Europe, driving investors to seek "safe-haven" assets amid concerns of a global slowdown.
- All 11 S&P sectors were down on the session. Consumer Staples (-0.3%), Utilities (-0.3%), and Consumer Discretionary (-0.8%) were the day's relative outperformers, while Materials (-2.3%), Energy (-2.3%), and Industrials (-2.4%) trailed the broader market.
- Rates fell across the curve as Treasuries gained on the day. Ten-year yields moved to 1.64% as of the 4 p.m. equity market close, and 30-year yields dropped to 2.10%. Outside of rates, gold gained following several negative sessions, though it closed below the symbolic $1,500 per-ounce level. The dollar fell slightly from its highest level since 2017, as measured by the US Dollar Index.

Catalysts for Market Move

Tuesday's down move appeared to be driven by weak global manufacturing data. While soft economic prints have been the trend over the last year in Europe, the addition of poor numbers out of the US took investors by surprise. Analysts had forecasted ISM Manufacturing to come in around 50 — the level separating expansion and contraction. The actual figure was 47.8, surpassing the prior low from January 2016 and representing the worst reading since the Financial Crisis. It was also the sixth straight month in which the survey result came in lower than the prior month. Market participants looked to the new economic data as the latest sign of a global growth slowdown and fresh evidence of the effects of the ongoing US-China trade dispute. Asset class performance on the session suggested a flight to quality, benefitting US Treasuries, gold, and "safe-haven" currencies like the Japanese yen. US data had held up better than the rest of the world for much of the year, so softening manufacturing sentiment as displayed in today's ISM report may point to growth converging with weakness abroad.

Even with today's sell-off, the S&P 500 still sits just 2.8% below last month's record high. Against the backdrop of Fed uncertainty, US-China trade concerns, and a decelerating economic and earnings growth outlook, equity markets may seem too sanguine. But outside of US stocks, markets seem to be showing more concern: Gold has rallied and sits near a six-year high. Ten-year Treasury rates have fallen roughly 0.5 percentage points since July and are near their lowest levels in three years. The 3-month/10-year Treasury curve remains inverted, which has historically been a negative harbinger for growth.

While in recent weeks market attention has been consumed by US-China trade developments and questions over the Fed's next move, deteriorating fundamentals also warrant monitoring. After two years of S&P 500 companies posting double-digit profit growth in 2017 and 2018, earnings per share for the index appears to have been roughly flat in 1H19, a dramatic slowdown that still does not appear fully priced into the index, which trades at nearly 17x consensus forward earnings estimates. We expect markets to remain volatile over the coming weeks and months, as US equities appear to be underpricing the risks of inflation, corporate margin compression, and a slowdown in capital spending. Uncertainty surrounding the Federal Reserve's next move could also weigh on markets. All this is occurring against a backdrop of ongoing trade tensions, which have the potential to negatively impact corporate confidence and investment, and could, in turn, serve as a further headwind to growth. As a result, we continue to suggest investors remain patient before putting fresh capital to work.

The Global Investment Committee's Outlook

The market environment in 2018 was one of the most challenging for equity investors since the Financial Crisis, with every region and most stocks delivering negative returns. Unusually, bonds and alternative investments simultaneously fared poorly, reducing the effectiveness of asset allocation in balancing out the losses with some gains. In sharp contrast with how 2018 ended, 2019 began with a sharp and broad rally across the majority of risk asset classes. Beginning in January, the dramatic pivot by the Federal Reserve to embrace a patient policy approach helped ease financial conditions and improve market sentiment. Overall, the GIC expects 2019 will be a better year than 2018 both in terms of absolute returns and the breadth of those returns. However, with significantly more good news currently priced into markets, the GIC advises caution as US stocks appear fully valued and earnings forecasts may have further to fall. While the GIC remains overweight equities relative to fixed income, it believes international stocks, particularly emerging markets, may offer the most upside potential going forward. Within fixed income, the GIC remains underweight corporate credit, and prefers high-quality, short-duration bonds as a proxy for cash, which it will look to deploy as opportunities arise. It also recommends a moderate allocation to long-duration Treasuries as a defensive portfolio hedge against the risk of a future equity or credit market correction.

Market data provided by Bloomberg.
Dow Jones Industrial Average (DJIA): A price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry.
NASDAQ Composite Index: A broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market.
S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.
US Trade-Weighted Dollar Index: A weighted average of the foreign exchange value of the US dollar against a subset of the broad index currencies that circulate widely outside the US.

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The value of **fixed income securities** will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk, liquidity risk, and credit risk of the issuer. **High yield bonds** are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues. **Duration**, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Alternative investments may be either traditional alternative investment vehicles, such as hedge funds, fund of hedge funds, private equity, private real estate and managed futures or, non-traditional products such as mutual funds and exchange-traded funds that also seek alternative-like exposure but have significant differences from traditional alternative investments. The risks of traditional alternative investments may include: can be highly illiquid, speculative and not suitable for all investors, loss of all or a substantial portion of the investment due to leveraging, short-selling, or other speculative practices, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than open-end mutual funds, and risks associated with the operations, personnel and processes of the manager. Non-traditional alternative strategy products may employ various investment strategies and techniques for both hedging and more speculative purposes such as short-selling, leverage, derivatives and options, which can increase volatility and the risk of investment loss. These investments are subject to the risks normally associated with debt instruments and also carry substantial additional risks. Investors could lose all or a substantial amount of their investment. These investments typically have higher fees or expenses than traditional investments.

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Because of their narrow focus, **sector investments** tend to be more volatile than investments that diversify across many sectors and companies. **Technology stocks** may be especially volatile.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

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