

October 11, 2019

What Happened in the Markets?

- US stocks rallied on Friday, with the S&P 500 gaining 32 points, or 1.1%, to close at 2,970. The S&P 500 has now rallied 18.5% year to date (price return), and sits just 1.8% below July's all-time high.
- There were several headlines contributing to today's sharp rally, perhaps most notably among them reports that a meeting between US and China trade negotiators was progressing well, with some form of trade "truce" likely to be announced Friday, though no such formal announcement had been released as of this writing (4 p.m. equity market close). Outside of the US, optimism that a Brexit deal may still be in reach also contributed to today's improvement in sentiment.
- Eight of the 11 S&P sectors rose during the session. Industrials (+2.0%) and Materials (+1.9%) led the market higher, while the rate-sensitive defensive sectors (Utilities, Real Estate and Consumer Staples) all finished lower on the session.
- Outside of equities, rates moved higher across the curve with the 10-year Treasury rate rising to 1.73% as of the 4 p.m. equity market close. The yield curve steepened, with long-term rates moving more sharply than front-end rates, with the 3-month – 10-year Treasury curve returning to positive slope for the first time in three months. Crude oil rallied more than 2% in Friday trading, while gold fell modestly. The US dollar also fell nearly 0.5%, as measured by the US Dollar Index.

Catalysts for Market Move

A strong finish to the week on Wall Street with the S&P 500 rallying 1.1%, to close at 2,970. With Friday's rally, the index has recovered all of its early-week losses, perhaps echoing last week's market action, which saw an early week slide for US stocks give way to a late-week rally that left the major averages only modestly lower for the week. Whereas last week's economic data appeared to be the driver of the back-and-forth action in equities, as markets digested a slew of mixed economic readings, this week's focus intensified on US / China trade relations, with markets reacting to various headlines concerning this week's meeting between high-level trade negotiators from both nations. It would appear that the meeting has not left markets disappointed, with both sides seemingly agreeing in "principle" to a "phase 1" deal regarding some trade issues, with expectations for talks to resume next month as negotiations continue. Importantly, Treasury Secretary Mnuchin confirmed that as a result of this week's talks, the US will not be implementing the next round of tariff increases on Chinese imports, which had been scheduled to go into effect next week. However, reports also indicate that the US has not yet made any decision with regard to the tariffs scheduled to go into effect in December. While official remarks on today's talks between the US and China have not been released as of this writing (4 p.m. equity market close), stocks did fade in the final 10 minutes of trading as statements from various trade officials were reported to the press.

While focus this week was clearly on trade and geopolitics, attention should return to corporate fundamentals next week as third quarter earnings season begins in earnest. With economic data looking mixed at best, and uncertainty on several fronts remaining elevated, any weakness in earnings reports or guidance could weigh on markets still trading near all-time highs. 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 more than 16.5x 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 has seen a sharp and broad rally across 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.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

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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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