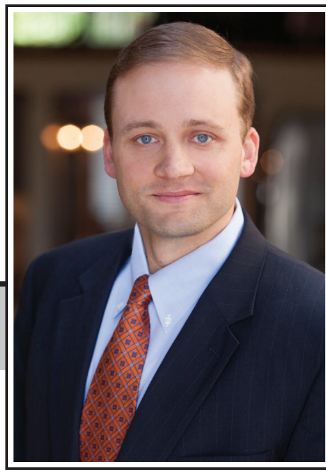
Sterling Advisors

THE MARKET MATTERS



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What Just Happened

The last full week of October hosted several of the most volatile trading sessions of 2018. October hosted the S&P 500's most down days in any month this year. The Dow Jones Industrial Average and the S&P 500 briefly erased the entirety of their 2018 gains, flirted with corrective levels (i.e., losses >10% from recent highs), only to return to modestly positive territory for the year. The VIX (Chicago Board Options Exchange SPX Volatility Index) reached levels unseen since February when stocks were in a state of revolt against rising U.S. Treasury yields (Bloomberg). Those emotions simmered to the surface once again – but the reasons for the latest rout were more widespread. Equities buckled under the pressure of rising global anxiety. Here we dig into the factors responsible for souring risk appetites and examine where we may go from here.

Rising Interest Rates – This is becoming a pattern. U.S. yields have established a clear bias toward higher levels. Subdued inflation, political uncertainty, and global demand for U.S. debt are restraining the pace with which U.S. yields are moving higher, but the broader trend is evident. However, when yields moved to recent highs within the context of all-time highs equity valuations, investors noticed the risk-reward disparity. Equity investors tend to grow uneasy when the yield differential between U.S. Treasuries and large-cap stock dividends reaches extreme levels (e.g., late January; mid-October). This time, as 10-Year U.S. Treasury (UST 10) yields tested 3.25% in mid-October relative to sub-2% yields from the S&P 500 Index, funds flowed out of U.S. equities and into safe-haven assets (Bloomberg). The equity-to-fixed income rotation relieved some of the pressure in the system, spurred along by a parade of downbeat economic and geopolitical developments. Stockholders felt vulnerable and sought the shelter offered by U.S. Treasuries – with fixed income's relative yield value providing an extra warm blanket.

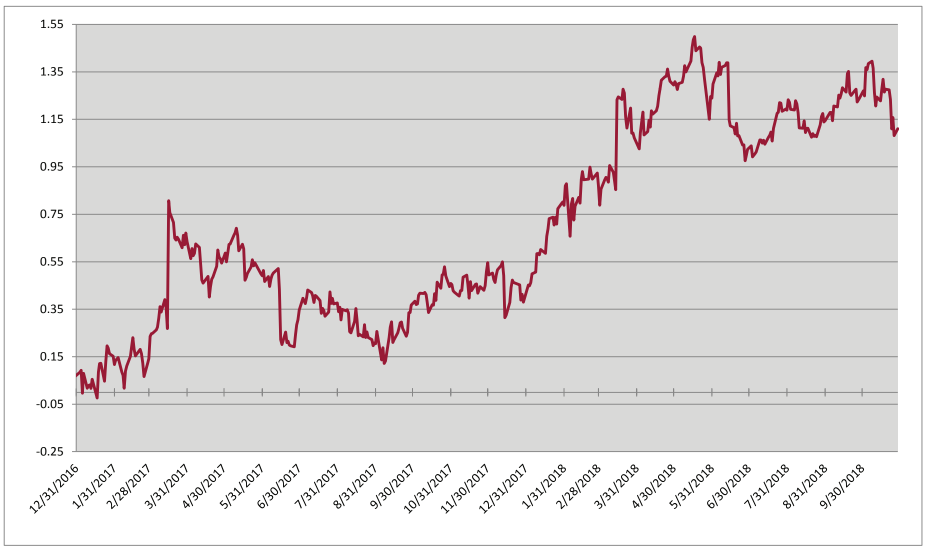

Figure 1: The yield differential between the S&P 500 and 10-Year U.S. Treasury yields since December 31, 2016
Source: Bloomberg

U.S. Corporate Earnings – Q3 earnings season is underway and, thus far, earnings look solid once again. Lower corporate taxes are boosting results and lower individual taxes appear to be supporting household income and consumption. That should give businesses the confidence to make capital investments and ramp up production. However, expectations were already set for exceptional earnings, which means simply 'good' results are being treated as a letdown. Furthermore, some major U.S. companies are revealing lower-than-anticipated, top line revenues and are revising future earnings expectations downward. That could be a cat-and-mouse game companies are playing to reduce the risk of over-promising and under-delivering in Q4. But for now, that is making investors nervous that the tax-related euphoria is wearing off and earnings have potentially peaked. The weaker sentiment compelled equity investors to take some risk off the table.

The U.S. Federal Reserve – The plan for up to five more hikes by YE 2019 is incongruous with U.S. inflation data, the fragility of our recovery and mounting global risks. Several weeks ago, Fed Chair Jerome Powell suggested the Fed is still a "long way" from reaching the neutral level of interest rates (i.e., the level that neither boosts nor restricts domestic growth). Though Fed officials have spent the last few weeks sweeping the off-the-cuff remark under the rug, market participants heard it loud and clear. The central bank continues to signal an aggressive game plan for normalizing monetary policy despite subdued inflation and moderated growth. Other major central banks around the world remain more cautious. But their trepidation actually buys the U.S. central bank time to be patient – an opportunity the Fed is ignoring. Instead, the Fed is marching toward a handful more rate hikes in relatively short order despite inflation expectations falling to their lowest point since January. If we view the U.S. economy as a train, the Fed is the conductor that must apply the brakes when the speeding train threatens to derail. Yet today, it's applying the brakes prematurely – just as the train is gathering steam.

Geopolitics – Each piece in this section warrants its own full-blown discussion. The condensed version: geopolitical uncertainty became too great for risk assets to ignore. New areas of concern are being added on a regular basis. The U.S.-China trade dispute rages on. Each side is standing firm and threatening further escalation through tariffs that, if executed, threaten global economic stability. The closely contested U.S. midterm elections on November 6 carry the power to boost, disrupt, or effectively destroy President Trump's agenda over the next two years. If November 2016 taught us nothing else, it showed how difficult it is to predict – let alone invest around – election cycles. The Brexit negotiation process, now well over two years old, remains in a state of constant flux, primarily over the treatment of Northern Ireland's border customs. U.K. Prime Minister Theresa May claims a deal is "95% done," but it is unclear how influential the last 5% will be in coming to terms. Italy, under new coalition leadership, has reached a budget impasse with European Union leadership. Italy's budget relies upon an unsustainable amount of new debt in the eyes of the EU. Italy remains on the verge of a banking crisis and its future as an EU member is in question. Recent Eurozone growth has looked fairly bleak. The last thing it needs is another challenge on its plate to go along with Brexit talks. Lastly, U.S.-Turkey-Saudi Arabia tensions are still sky-high following the murder of Jamal Khashoggi in Istanbul. President Trump had affirmed Saudi Arabia's role as a key ally in the region and hoped to partner with the country to apply pressure on Iran. Khashoggi's murder complicates those efforts. Turkey President Erdogan is demanding Saudi Arabia turn over 18 suspects to Turkish officials as a sign of goodwill, but Saudi Arabia has yet to respond.

Conclusion – There is always uncertainty. Uncertainty begets volatility. When anxiety outweighs optimism, the aggregate result is risk-off. Bond prices typically benefit from this sentiment and yields fall. Higher interest rates, weaker earnings guidance, a hawkish Fed, and a bustling geopolitical stage removed some of the equity market's froth. In doing so, they simultaneously reinstated demand for U.S fixed income. This highlights the importance of staying diversified. High-quality fixed income created a valuable buffer for portfolios during late-October's tumult. One difference lately: the magnitude of the volatility. Why are the market jolts of late more powerful? The era of massive monetary stimulus is coming to an end in the U.S. Virtually all assets were stabilized by the Fed's quantitative easing program. That support is being actively reduced. The amount of liquidity in the system is falling. Markets no longer have the central bank in the background smoothing out the ride. Investors must emphasize the fundamentals and can no longer rely upon monetary policy for assistance. Current U.S. fundamentals are strong. However, some of the conditions that helped create today's economic stability are beginning to recede. At the end of October, investors took note.