MARKET COMMENTARY

INVESTMENT STRATEGY GROUP
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Navigating Through a Market Sell-Off

Backdrop

The market sell-off began over the last week and a half, with the S&P losing more than 5% over the last two days. There are many challenges in the investment environment, making it difficult to pinpoint a single reason for the decline:

- The Federal Reserve (Fed) has been raising interest rates. Chairman Powell's comments last week accelerated yield moves higher recently.
- Trade discussions have created uncertainty between the U.S. and the rest of the world, particularly China. This has fueled greater uncertainty about global growth prospects.
- A low unemployment rate has caused speculation about increased wage pressures, resulting in potential downward pressure on profit margins.
- Oil supply concerns have driven commodity prices higher.
- Automated trading has contributed to market price swings.

Although the markets are recovering some, we wanted to share our view and response to scenarios like these in light of the recent market volatility.

We believe that it is important to humbly admit that the future is uncertain. Will the Fed lose control? Will the trade war with China grow into something bigger? Will low unemployment lead to a spike in inflation? We don't believe anyone can know the eventual effect of these events on markets. Yet markets hate uncertainty, so "sell first and assess later" is a typical market response. Given the uncertainty around these specific events, what can we turn to?

Based on our investment principles, we believe that outcomes cannot be guaranteed, but that there are known data points that can help us greatly in navigating the uncertainty. We appeal to three things consistently in our investment process: finding areas of relative economic growth and strength, evaluating the price paid for assets, and diversifying based on when our clients need to use their funds. In terms of the market events of the last week, our focus will turn to valuations.

What do we know about valuations?

We believe that current asset prices have been based on (artificially) lower interest rates for several years. Lower rates encouraged investors to take more risk by buying more equities. As the Fed seeks to withdraw stimulus from the economy (by raising interest rates), stock prices adjust accordingly. Artificially depressed interest rates create imbalances in the economy that eventually need to correct, which means valuations for risky assets will have to fall. Whether that happens all at once or gradually through time, no one knows.

So, if stocks are too expensive, why invest in them at all?

If your time horizon is one or two years, we'd be hard pressed to give you a good reason to invest in stocks. The risk is simply too high. Longer term, the growth in dividends and earnings will more than likely offset the expected valuation decline in our view. However, returns may be marginal for U.S. equities as they are much more overvalued than the rest of the world, which is why we favor international stocks currently.

What's next?

The Fed will likely use market reactions as a guide, potentially delaying future rate hikes if the market is sent into a tailspin. Will that indeed happen? Economic expansions don't die of old age. They typically end from policy missteps, which become more likely following a decade of aggressive monetary policy like we've had. Prices, in our estimation, are ahead of fundamentals. This combination leads us to believe that increased market volatility is likely.

While we see lots of uncertainty in the near term, there seems to be broad agreement amongst investment professionals on long-term market direction.

What does this mean for you?

We believe that despite the very real discomfort of events like the current market sell-off, we encourage investors to remain calm. Prices fluctuate in the short term based on sentiment. When the market panics, prices usually drop by more than what is justified by fundamentals. In our view, that's not the case this time; we believe that the drop in stock prices is a healthy correction that brings prices closer to proper valuations.

Fundamentally, prices are driven by the price paid for a level of growth. We still believe that investors will be rewarded for owning stocks over the long term despite steep valuations. Additionally, we believe that a globally diversified portfolio of stocks has a higher probability of rewarding investors. The key is making sure that the time horizons match between your investment portfolio and when you need to use the cash. That's the reason to stay invested in risk assets. We believe that patience in the face of discomfort will likely, as in the past, be rewarded.

We appreciate the trust you have placed in our firm to help you steward your finances. Please feel free to reach out to your advisor with any questions or to schedule a call with one of our investment strategists.