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# Market Flash

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## Stock market sell-off: The sequel

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After a pause in which stocks partially recovered from their early October drop, the stock market has moved back into sell-off mode yet again.

**What drove the sell-off?**
We believe both of the October sell-offs can be largely attributed to the two key risks we have identified and been discussing all year: monetary policy normalization and rising protectionism.

For this most recent market drop, there were two trade-related catalysts and one related to rising rates:

- Recent earnings outlooks from industrial companies have indicated that input costs are increasing.
- There are concerns that increased pressure from US tariffs is exacerbating what would otherwise be a modest economic slowdown in China.
- Markets received news that foreign purchases of US Treasuries have slowed considerably in 2018, while at the same time there are more Treasuries because of balance sheet normalization and a growing deficit.

**Earnings outlooks.** Caterpillar and 3M indicated in their earnings outlooks that input costs are rising, and that of course can be attributed largely to tariffs. This is causing concern among investors that at least some companies have reached peak profits. We're not surprised to see that, while earnings for the third quarter are strong, tariffs are being mentioned in earnings outlooks. It was only a matter of time before they started impacting companies and their bottom lines. Recall that we recently heard from Fastenal, which also indicated that tariffs are impacting its business by disrupting its North American supply chain.

**Impact of tariffs on China.** China's efforts toward deleveraging and supply-side reforms were orchestrated to create a very gradual slowdown with the least amount of disruption possible. And China had already begun to make progress in this regard, with China's credit metrics already improving.[1] Then along came the US' trade dispute with China, which has been putting greater pressure on China's economy – which in turn is worrying investors. The recent drop in copper prices is one indication of concern about Chinese economic growth. President Xi Jinping temporarily calmed markets with his comments last weekend committing to support the Chinese economy. However, market jitters returned yesterday.

**Foreign purchases of US Treasuries.** Foreign purchases of US Treasuries continued in the first eight months of 2018, but at a much lower rate than the previous year. This has been occurring just as the US is issuing more debt – and also putting more Treasuries into circulation through balance sheet normalization. Continued lack of demand threatens to drive up borrowing costs, which is a negative for stocks; just think of what the spike in the 10-year Treasury yield did to put downward pressure on stock prices earlier this month.

**Key takeaways**

- After a pause in which stocks partially recovered from their early October drop, the stock market has moved back into sell-off mode yet again.
- For this most recent market drop, there were two trade-related catalysts and one related to rising rates.
- These risks have been growing for some time, and so we don't expect them to go away overnight. We expect increased volatility to continue, especially downside volatility.

**Other geopolitical disruptions have exacerbated the situation.**
We see a confluence of major national and global factors underlying these "risk-off" episodes:

- **Italy.** One major source of tension in Europe, and by extension in global markets, is the budget standoff between the European Union (EU) and Italy. We expect eventual compromise, but also anticipate volatility and widening spreads in the shorter term.
- **Brexit.** Risks are rising that there may be a "no deal" Brexit. In our view, neither the UK nor EU are fully prepared for this eventuality — nor for the risk that such a scenario could spark greater worldwide fear of financial and economic fragmentation. Our base case is an optimistic one: Rather than a crash, we still expect a "soft Brexit" (a transition out of the EU based on World Trade Organization rules), but the devil will remain in the details — and in the risk scenario. And so we expect this to contribute to volatility and uncertainty in the shorter term.
- **Saudi Arabia.** We expect the furor over the alleged Saudi killing of a dissenting journalist to persist, with considerable discussion and debate in the media, but we do not expect it to lead to any major breakdown in trade or financial ties with the key countries involved. The US' special relationships with Turkey and Saudi Arabia are too valuable in terms of NATO, the Middle East and energy to lead to a breakdown, in our view. Another reason we believe there will be no major breakdown in relations is because that might benefit US rivals — Russia and China in particular — and the US would not want that to happen. We believe that view is reflected in the recent weakening in oil prices; if rising geopolitical threats to oil supply were anticipated, we would expect oil prices to be rising rather than falling. Even so, the bilateral tensions are likely to persist, along with the risk of future challenges to Saudi reform plans and Turkey's financing needs. Risk premia in both countries and in the region more generally are likely to remain volatile with spillover risks across the Gulf, in our view.
- **Rising US-Russia-China tensions.** The United States has indicated that it may withdraw from the Intermediate Nuclear Forces (INF) arms control treaty with Russia, citing concerns about Russia's own adherence, China's lack of participation and, by implication, rising national security concerns about both these geo-strategic rivals. This is yet another salvo in the direction of partial fragmentation of the global economy along geopolitical fault lines — and it suggests that there is no easy climb down from tensions among the world's three leading military powers. This could add to volatility going forward.

**What are the investment implications?**
We expect continued volatility for equities, fixed income and commodities. Concerns about the economic impact of tariffs are likely to continue depressing commodity prices, in our view, while we expect gold to move higher as it becomes a slightly more desirable "safe haven" asset class than it has been in the past few years due to recent volatility in Treasuries.

**What is our outlook on the situation?**
We have been warning for more than a year that the two key risks to the economy and markets are normalization by the US Federal Reserve and protectionism. It seems that these forces are both at play, creating something of a "perfect storm" that is causing market disruption. Adding to that are various geopolitical disruptions around the world. However, the reality is that longer-term investors need capital appreciation potential in order to achieve investment goals — and so we believe they should consider maintaining exposure to risk assets, but with an emphasis on downside protection. Therefore, this could create an opportunity for active management, especially in certain asset classes.

We have also been warning that these risks underscore the importance of broad diversification — that means diversification within equities (by region and factor) and fixed income (by sub-asset class) but also adequate exposure to alternative asset classes, which have historically exhibited lower correlations to equities. Unless an investor has a short time horizon, we believe it is important to maintain exposure to a broadly diversified investment portfolio that includes risk assets. In addition, tactical investors can take advantage of buying opportunities created by the sell-off.

**What are we watching for?**
These risks have been growing for some time, and so we don't expect them to go away overnight. We expect increased volatility to continue, especially downside volatility. We will want to follow the trade situation closely. If it deteriorates significantly, an overweighting of relatively liquid instruments within each asset class or even reduced exposure to risk assets may be warranted.

1 Source: S&P Global Ratings, "China's Long Credit Cycle Has Ended and Deleveraging Has Begun: Can It Be Sustained?" August 2018

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Diversification does not guarantee a profit or eliminate the risk of loss.

In a "no-deal" Brexit, the UK would leave the EU in March 2019 with no formal agreement outlining the terms of their relationship.

A risk premium is the amount of return an asset generates above cash to compensate for the higher risk.

Safe havens are investments that are expected to hold or increase their value in volatile markets.

Risk off refers to price behavior driven by changes in investor risk tolerance; investors tend toward lower-risk investments when they perceive risk as high.

Fluctuations in the price of gold and precious metals may affect the profitability of companies in the gold and precious metals sector. Changes in the political or economic conditions of countries where companies in the gold and precious metals sector are located may have a direct effect on the price of gold and precious metals.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

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