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## Stock losses snowball across the globe in a December sell-off

We expect continued volatility as markets overreact to positive and negative news

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US stocks began a dramatic sell-off on Tuesday that has continued and spread to other parts of the world, creating intense headlines across the globe on Thursday. There has been a flight to the perceived safety of sovereign debt. The yield on the 10-year US Treasury fell dramatically, from more than 3% at the start of the week to 2.83% as of this writing<sup>1</sup> – and other major sovereign debt yields also followed suit. Some areas of the yield curve inverted, and the 2-year/10-year yield curve is in danger of inverting.

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### What is our take on what is happening?

It is clear to me that on Monday, investors positively overreacted to news that the trade talks went well between US President Donald Trump and Chinese President Xi Jinping at the G-20 meeting. And then they negatively overreacted to news that Robert Lighthizer will lead trade talks with China going forward. They negatively overreacted even more to the news that the chief financial officer of Chinese tech company Huawei was arrested, as this has implications for US-China trade relations.

### We have to put this in perspective.

Going into the G-20 meeting, all we could reasonably hope for was a moratorium on tariffs – and that's all we got. In my view, we have to assume the trade truce will be relatively short-lived and the situation is likely to deteriorate. I believe the US will ultimately capitulate to China – but only after enough cracks appear in the economy. This is one reason that I do not fear data showing an economic slowdown.

Investors are clearly also worried about signs of a global growth slowdown, which have begun to appear in the data. However, investors seem to have forgotten the reassurances provided by the US Federal Reserve (Fed) last week – that it remains data dependent and is not on a pre-set course. In other words, if enough data suggests a deteriorating economic situation, the Fed is likely to take its foot off the accelerator in 2019. This is another reason why I do not dread data indicating an economic slowdown. One fly in the ointment is if we get data suggesting inflation is rising significantly, which may reduce the flexibility of the Fed to ease up on its normalization path in 2019.

Investors have also become fixated on the yield curve and the possibility of an inversion – which has historically been a good predictor of recession – as the yield on the 10-year Treasury comes close to the yield on the 2-year Treasury. I do not expect the yield curve to invert in the short term. And if it does in fact invert, we need to recall that since 1978, the average lag time between yield curve inversion and recession has been 21 months.<sup>2</sup>

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### What are the investment implications?

We expect continued volatility for both equities and fixed income. It seems we have entered a period in which investors are overreacting to both the upside and the downside, a condition that is being exacerbated by program trading (trading by computer algorithm). Concerns about economic growth and uncertainty about OPEC oil production are likely to continue to depress commodity prices as well. We expect gold to move higher.

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**What is our outlook on the situation?**

We have been warning for more than a year that one of the key risks to the economy is protectionism. Adding to that are concerns about an economic slowdown as well as other geopolitical disruptions around the world, from Brexit uncertainty to US-Russia nuclear weapons tensions. However, the reality is that longer-term investors, especially institutional investors, need capital appreciation potential in order to achieve investment goals. I believe this warrants continued exposure to risk assets such as stocks, but with an emphasis on downside risk mitigation. Therefore, we reiterate 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 not only means diversification within equities (by region and factor) and fixed income (by sub-asset class), but also adequate exposure to alternative asset classes. 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.

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**What are we watching out for?**

We will want to follow the trade situation closely, as well as global growth data. If we see significant deterioration in either area, an overweighting of relatively liquid instruments within each asset class or even reduced exposure to risk assets may be warranted. We will be watching the US employment situation report tomorrow – particularly average hourly earnings – for signs that wage growth is rising significantly. And of course we will be very focused on the December Fed meeting – and the December European Central Bank meeting – for the messaging we receive on their economic outlooks for 2019.



1 Source: Bloomberg, L.P., as of Dec. 6, 2018

2 Sources: FactSet Research Systems and the National Bureau of Economic Research

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