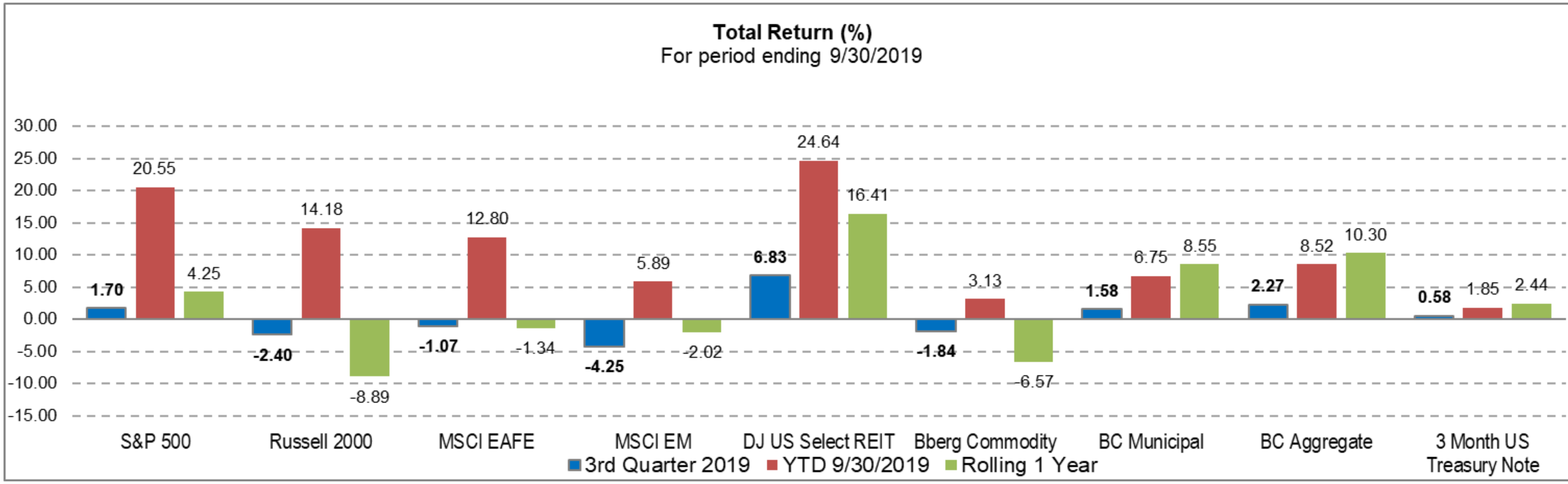
Volatility & The Spin Cycle

Why We Still Believe in Diversification

Schneider Downs Wealth Management Advisors, LP
Q3 2019 Market Commentary

Big Thinking. Personal Focus.



If one were to solely judge the results of the third quarter by looking at the returns denoted in the blue bars in the above chart, a person easily could come away with the impression that it was a mixed bag and largely uneventful. However, the old English idiom "Do not judge a book by its cover," is the most appropriate mindset to use when evaluating the results in the third quarter. While July was mostly quiet, August provided market participants a sharp increase in volatility (and heartburn). The sharp increase in volatility was driven by investors' fears about slowing global growth and, more acutely, the increased possibility that the U.S. economy is heading toward a recession. The triggering event was the breaching of a historically-important recession indicator: the yield on the 2-year U.S. Treasury note became greater than the yield on the 10-year U.S. Treasury bond.[1] In response, U.S. equity markets fell in excess of 3% on August 14th. With the large drop in the markets came the sensationalized headlines from the media. SDWMA sent out an email to our clients urging caution; that while an important economic indicator was breached, a broader basket of indicators was sending a more mixed message. Equity markets would go on to rally (U.S. stocks ~+5% and International stocks ~4.7%[2]) off their August lows, aided by another interest rate cut by the U.S. Federal Reserve[3], as well as solid unemployment and wage growth. Volatility in capital markets can cause consternation and very real and valid questions about your asset allocation and future expected rates of return. However, making decisions about your asset allocation based on one number or event often leads to suboptimal decisions and results. Investing is a long term proposition that requires dealing with short term ebbs and flows in order to reach a larger goal. As the volatility of the third quarter reminded us, longer term positive rates of return aren't risk free.

U.S. large cap stocks were once again the best returning asset class in the third quarter, outpacing its mid- and small-sized counterparts domestically. Despite escalating rhetoric and the implementation of certain tranches of tariffs between the U.S. and China, the S&P 500 delivered a +1.7% return for the quarter (at one point in mid-August, the S&P 500 was -4.5%). The much lauded FAANG stocks (Facebook, Apple, Amazon, Netflix, and Google) exhibited some weakness in the quarter with Netflix down ~-27%, Amazon down ~-8%, and Facebook down ~-7%. Value stocks (much beleaguered for most of the past ten years) began to show signs of strength, particularly following the drawdown in August. U.S. small cap stocks continued a concerning trend, with the Russell 2000 returning -2.4% for the quarter, lagging their large and mid-cap cousins once again. While one quarter is not cause for concern, what is concerning is that the Russell 2000 has been unable to regain all of its losses from the fourth quarter of 2018. Sustained weakness in U.S. small cap stocks has historically suggested a domestic economy that is more fragile than it appears.

[1]*https://finance.yahoo.com/news/yield-curve-inverts-for-first-time-since-2007-102034083.html*
[2]*S&P 500 was +5.06^% from August 15th through September 30th; MSCI EAFE was ~+4.7% from August 15th through September 30th. Source: Morningstar Direct*
[3]*https://www.cnbc.com/2019/09/18/fed-decision-interest-rates-cut.html*

International equities struggled to find their footing in the third quarter as the effects of the U.S.-China trade war spilled into global markets. International developed stocks, as measured by the MSCI EAFE, were down -1.07%, while International emerging market stocks, as measured by the MSCI EM, were down -4.25%. Germany, the strongest and largest economy in the European Union, finds itself in an industrial recession and on the verge of a broader, fuller recession.[4] China is an important trading partner with Germany, and as the Chinese economy has slowed due to the prolonged tariff dispute with the U.S., Chinese consumption of German goods has contracted. While the pain of a slowing China is most impactful to the German economy, it has affected broad swaths of the European Union as well. In addition, international developed equities are dealing with the never-ending saga of BREXIT, which enters its fourth year without a resolution.[5] The SDWMA team has spoken over the past two years about the relative attractiveness of international stocks, both developed and emerging, from a valuation standpoint. The team still feels that they represent a compelling intermediate to longer term investment proposition. However, too many headwinds in the short term prevent the team from making a significant change to our asset allocations.

Buoyed by two interest rate cuts by the U.S. Federal Reserve, bonds rallied in the third quarter as yields fell and prices rose. High-quality taxable bonds, as measured by the Barclays U.S. Aggregate Bond Index, have returned +8.52% for the year (+2.27% for the quarter). Tax-free municipals saw increased demand, advancing +1.58% for the quarter and moving to +6.75% for the year. The good news for investors is that core fixed income has delivered very attractive returns. The bad news is that interest rates are dramatically lower than they were at the beginning of the year. When looking at future expected rates of return, the investment team generally forecasts the majority of the return of core fixed income to come from the yield (cash flow) with a minimal amount of price appreciation. Given where interest rates and bond yields currently reside, we expect a lower rate of return for core fixed income going forward. With respect to our fixed income allocation, and as a result of being less tethered to interest rates, our “Strategic Income” bucket (strategies that serve as a complement to our high quality core strategy) have done well by adding diversification and higher income streams.

As we enter the fourth quarter of 2019, investors find themselves in a similar spot to where they were in 2018. U.S. equity markets appear very strong on the surface, but underneath, there are some serious questions about the strength of the U.S. economy. The U.S. and China still find themselves in an ever escalating trade war; the United Kingdom has still not resolved its BREXIT plans; and the Middle East remains in conflict with Saudi Arabia and Iran fighting proxy wars throughout the region. One of the main reasons SDWMA believes in having diversified portfolios is the ability to blunt the daily swings in the market by spreading risk across stocks and bonds with a smaller allocation to lower correlation alternative equity strategies. While a diversified portfolio means you will likely not have 100% exposure to the best performing asset class, you will also likely not have 100% exposure to the worst. By spreading the risk in your portfolio across different asset classes, we believe it increases an investor’s ability to handle days like August 14th, months like May and August of this year, and quarters like the fourth quarter in 2018. Entering the fourth quarter, there remains more questions than answers, which likely means more volatility as we make the final stretch into year end. The SDWMA team is focused on ensuring our client portfolios remain aligned with our clients’ longer-term objectives. If there are changes to your goals or objectives, or if the volatility of the third quarter was too much for you to stomach, please reach out to your SDWMA advisor to set up a call to discuss the portfolio. Thank you again for your trust and partnership.

[4] *https://www.bloomberg.com/news/articles/2019-09-23/germany-may-see-no-growth-this-year-as-manufacturing-slumps*
[5] *https://en.wikipedia.org/wiki/Results_of_the_2016_United_Kingdom_European_Union_membership_referendum*