# Markets Corrected by Rising Rates

October 2018

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- October saw the broad-market S&P 500 Index fall over 10% from its recent peak.
- A key trigger for the jump in market volatility and selloff in risk assets was the Federal Reserve's move in September to raise interest rates.
- The increased market volatility supports the conviction that investors should maintain a diversified, long-term outlook.

After recovering from a 10% correction early in 2018, most U.S. equity indexes had posted significant year-to-date gains by the end of the third quarter. However, October saw the broad-market S&P 500 Index re-enter correction territory—that is, down over 10% from its recent peak—for the second time in less than 12 months.

Global equity markets were also hit hard as we entered the final quarter of the year, with the FTSE 100 Index in correction territory and on track for its worst monthly performance in a decade. European shares, as measured by the STOXX Europe 600 Index, fell to their lowest levels in nearly two years.

**Why Now?**

Why is this happening now? A key trigger for the jump in market volatility and selloff in risk assets was the Federal Reserve's move in September to raise interest rates for the fourth time in a year, bringing its key lending rate to 2.25%—with intentions to issue yet another hike in December. Also unsettling the markets was the European Central Bank messaging that it will withdraw quantitative easing (stimulus) from the economy before the end of the year.

Brexit-related uncertainty continues to fuel doubts in the U.K., creating a headwind for U.K. equity performance. A falling pound and weak U.K. economic data over the past year have been driven by anticipated implications of a hard Brexit (the likelihood of which appears high). Political unpredictability is also on the rise. The plan recently put forth by Prime Minister Theresa May was given a frosty reception by the EU and by her pro-Brexit rivals within the U.K.'s Conservative Party. UK inflation has shown signs of acceleration, complicating monetary policy for the Bank of England.

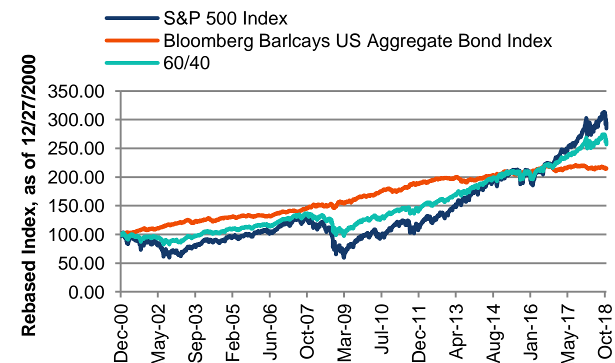
Beyond the Brexit drama, geopolitical fears exacerbating the global selloff have included Italy's debt situation and ongoing trade-war rhetoric, a slowdown in Chinese growth, and a disappointing batch of third-quarter earnings in the U.S. (particularly in the technology sector).

**Diversification Can Dampen Volatility**

The increased market volatility supports the conviction that investing in capital markets involves risk. We believe that, whatever amount of risk an investor chooses to take, that investor should receive as much expected return as possible in exchange for assuming that degree of risk.

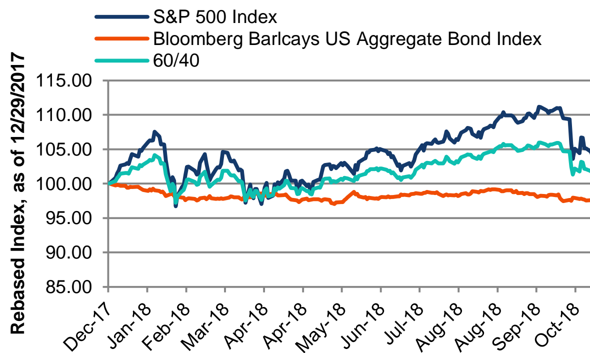
The charts below show the returns of both the S&P 500 Index and Bloomberg Barclays US Aggregate Bond Index over the last 18 years and the year to date, along with how a portfolio would have performed during these periods if it held 60% in the equity index and 40% in the fixed-income index. While this diversified portfolio would have fallen just short of the S&P 500 Index over both time periods, it also would have subjected the investor to less volatility than a more concentrated portfolio during both periods.

**Concentrated vs. Diversified Returns: Past 18 Years**




Source: Bloomberg

**Concentrated vs. Diversified Returns: Year to Date**




Source: Bloomberg

As illustrated in these two charts, performance patterns tend to shift (often unpredictably) over time. While diversified portfolios can undergo periods in which they lag concentrated portfolios, we do not believe this dilutes the importance of diversification for long-term investors. The key to getting through these less-fruitful cycles is, in our view, being aware of concentrated market leadership and remembering that performance patterns often change.

**SEI Strategies**

Our stability-focused strategies have benefited from strategic exposures to low-volatility equities that have outperformed (net of expenses) the broad-market indexes in October. Additionally, while investment-grade fixed income has faced headwinds from rising rates for much of the year, it has served as ballast against equity declines during the recent market volatility. Our growth-focused strategies have benefited from tactical positioning, namely a preference for value-oriented stocks at the expense of growth-oriented stocks. As always, we continue to adhere to our philosophy of constructing well-diversified portfolios with an eye on long-term goals.

**Our View**

We believe the fundamental outlook remains favorable for U.S. equities, despite trade-war concerns and the rising trend in interest rates. Tax cuts, deregulation and strong revenue growth have provided an ideal backdrop for U.S. equities to appreciate, but performance could be constrained if earnings estimates fade in light of increasing tariffs on tradable goods. The multiple on those estimated earnings also could fall if interest rates climb at a faster-than-expected pace. That said, we still think it's premature to turn negative on the near-term outlook given today's mosaic of economic fundamentals. In our view, the risks to the U.S. stock market are evenly balanced.

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**Index Definitions:**

**Bloomberg Barclays U.S. Aggregate Bond Index:** The Bloomberg Barclays US Aggregate Bond Index is a benchmark index composed of U.S. securities in Treasury, Government-Related, Corporate and Securitized sectors. It includes securities that are of investment-grade quality or better, have at least one year to maturity and have an outstanding par value of at least $250 million.

**FTSE 100 Index:** The FTSE 100 Index measures the performance of shares from the 100 largest companies listed on the London Stock Exchange.

**STOXX Europe 600 Index:** The STOXX Europe 600 index is an unmanaged index of 600 large-, mid- and small-cap companies that represent approximately 90% of the market capitalization of the European stock markets.

**S&P 500 Index:** The S&P 500 Index is an unmanaged, market-weighted index that consists of 500 of the largest publicly traded U.S. companies and is considered representative of the broad U.S. stock market.

***Important Information***

*This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.*

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*The performance data quoted represents past performance. Past performance does not guarantee future results.*

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