MARKET COMMENTARY:
Recent Market Volatility
October 26, 2018

After finishing the 3rd quarter squarely in positive territory, US stocks have given up nearly all of their year-to-date gains so far in October. By Friday the 26th, the S&P 500 Index had fallen nearly 8% from its record high (which it set just five weeks ago), putting it near correction territory. For the year, the index is now just barely positive. Broader US indices are faring even worse, with the Russell 3000 Index (representing around 98% of listed US securities) returning -8.94% for the month versus -8.40% for the S&P 500.

Yet broad market performance doesn't tell the full story. Growth stocks have seen an even bigger pullback than the overall market. The Russell 1000 Growth Index is down 10.04% for the prior month, compared to 7.28% for the Russell 1000 Value Index. Meanwhile, the technology-heavy NASDAQ Composite has fallen even further (-10.26% for the month).

Internationally, the picture is similar, as non-US developed and emerging markets stocks (as measured by the MSCI EAFE and MSCI Emerging Markets indices, respectively) are both down over 10% for the past month. Year-to-date losses for these markets total 10% and 17%, respectively.

What are investors to make of recent market turbulence? To answer this question, we should first assess where we appear to be in the current market cycle.

- Economic growth in the U.S. accelerated in Q2 to 4.2% despite increasing trade war fears. The U.S. economic expansion (recovery), now at nine years, is the second longest in history and well above the average recovery length.
- The Federal Reserve recently raised the Fed Funds rates to 2.25%, the third increase in 2018. Its slowly shrinking balance sheet is another sign of monetary policy that is transitioning from accommodative to restrictive.
- The unemployment rate fell to 3.7% during Q3, a level last seen in 1969. It was 4.1% at the start of 2018.
- The Treasury yield curve has flattened to the point that 10-year Treasuries are presently yielding 3.07%, while 2-year Treasuries are yielding 2.81%. Historically, as the spread between the two approaches zero, a market correction has shortly followed.

All of these observations lend themselves to the conclusion that we are in the latter stages of an expansion. At some point in the not-too-distant future, we are likely to see some contraction in economic growth, which may coincide with a market correction. While economic slowdowns and market corrections can be unpleasant, they are completely normal, and set the stage for future growth.

With that being said, recent market events may not be indicative of an impending end to the present bull market cycle. Indeed, many economists expect the US economy to continue growing robustly for the foreseeable future.

Why, then, have we seen such a significant turnaround in market performance? There are several possible explanations for the market's swings over the last few weeks.

- Falling tech revenues – Two leading technology firms reported quarterly profits that beat Wall Street estimates last Thursday, but their top-line revenue figures disappointed the market. This comes as investors are on the lookout for fallout from global trade tensions on corporate earnings and growth.
- Stock market valuations – Equity valuations have been rising throughout this bull market. Some measures, like the Shiller Cyclically Adjusted P/E Ratio (commonly called the CAPE) are at levels last seen during the tech bubble in the late 1990s. Technology stocks in particular have seen massive runups in 2018, and investors may be starting to doubt that these companies will be able to deliver earnings commensurate with their stock prices.

- Interest rates – Interest rates are trending upward, particularly on the short end of the curve. As interest rates rise, bond returns become more competitive with stock returns, and it becomes increasingly difficult to maintain elevated stock prices (as measured by P/E ratios).

At this point, the recent market pullback is a minor dip in a long bull market. While it is possible that the dip is indicative of a coming recession, that is not particularly likely at this point based on current economic indicators. For instance, new data released by the Commerce Department last Friday show that the US economy grew at a solid 3.5% in the 3rd quarter, surpassing estimates. It is somewhat more likely that recent market movements are the beginning of a rotation from growth to value stocks, although this has yet to be seen.

Over the mid-term, it will be interesting to see how market conditions impact the Federal Reserve's monetary policy plans, which are currently expected to include one more rate hike in 2018 and three in 2019.

Accurately predicting equity market movements is ultimately impossible. Recent volatility simply reinforces the need to maintain diversification across various investment styles and geographies. As always, we continue to urge investors to take a long-term perspective when these types of events occur and to not overreact in response to short-term market swings. Investors should review their objectives, goals, risk profiles and their investment time horizons before making any significant portfolio changes.

SageView will continue to monitor this market volatility and provide updates as necessary. If you have questions or need additional information, please do not hesitate to contact us.

The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

*The **MSCI EAFE** is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East) excluding the U.S. and Canada. The Index is market-capitalization weighted.*

*The **MSCI Emerging Markets** is designed to measure equity market performance in global emerging markets. It is a float-adjusted market capitalization index.*

The Nasdaq Composite is an index of the common stocks and similar securities listed on the NASDAQ stock market and is considered a broad indicator of the performance of stocks of technology companies and growth companies. Đ

*The **Russell 1000 Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.*

*The **Russell 1000 Value Index** measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower forecasted growth values*

*The **Russell 3000** Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market.*

*The **Shiller Cyclically Adjusted P/E (CAPE) ratio** is a valuation method using real earnings per share over a 10-year period to account for fluctuations in corporate profits occurring over different periods of a business cycle. The ratio is generally applied to broad market indices to determine if the market is undervalued or overvalued.*_