10/25/2018

Look Beyond the Quintuple Whammy

Yesterday was another down day for U.S. stocks as the S&P 500 lost over 3%, marking the 13th declining day in the past 15 trading sessions. The NASDAQ Composite and the Dow Jones Industrial Average fell in sympathy, dropping 4.4% and 2.4%, respectively. With yesterday's sell-off, both the S&P 500 and Dow Jones Industrial Average wiped out all their gains over the past 10 months to turn negative for 2018. The primary causes for this jump in volatility and multiple day sell-off are what we term the Quintuple Whammy – rising interest rates, a stronger dollar, higher oil prices, weakness in cyclicals, and rising global concerns. While these are at the forefront of investors' minds today, there are positives that provide optimism for the balance of this year.

In our opinion, the recent market weakness is attributed to five primary market concerns called the Quintuple Whammy:

- **Rising interest rates and the Fed.** The strong U.S. economy continues to put upward pressure on bond yields and the Federal Reserve (Fed) to accelerate the pace of raising interest rates.
- **Stronger dollar.** The combination of higher interest rates, a strong domestic economy, and growing global concerns (discussed below) has caused the U.S. dollar to appreciate relative to major foreign currencies. Investors are worried that the stronger dollar will hurt U.S. exports.
- **Higher oil prices.** Though they have contracted a bit recently, the sanctions on Iran, uncertainty in Venezuela, and a looming political crisis in Saudi Arabia put upward pressure on oil prices this year. Investors fear that higher energy costs could crimp consumer spending.
- **Weakness in cyclicals.** Generally, there are two broad categories of equities – cyclicals and defensives. Cyclicals, such as homebuilders, construction companies and materials producers, are economically sensitive and tend to perform well when the economy is strong. Investors have been concerned about the relative weakness of cyclicals versus defensives. For example, the three of the four worst performing S&P 500 sectors this quarter are cyclicals – Materials, Industrials, and Consumer Discretionary. Investors consider this a sign that the higher energy, labor, and borrowing interest rates are negatively impacting the U.S. economy.
- **Rising global concerns.** While the U.S. economy is rolling along, it is not the case with the rest of the world. In China, economic growth is showing signs of slowing on weaker consumer spending driven by aging demographics and exacerbated by its one-child policy of the '80s. The trade war with the U.S. has not helped. In Europe, Italy is battling the European Union (EU) over its budget while Brexit, the impending withdrawal of the United Kingdom from the EU early next year, is still not complete and the final agreement appears deadlocked. Overhanging all of Europe is economic uncertainty as recent reports suggest a six-year low in manufacturing activity and a four-year low in overall optimism.

A consequence of this Quintuple Whammy is that market volatility has returned. Though it may not feel like it, surprisingly it is not above historic levels. As seen in the chart below, for nearly three decades, the S&P 500 has averaged a one percent or greater swing about 25% of all trading days (average of 63 times per year). Last year, market volatility pretty much disappeared as these swings occurred just eight times. Though this year's volatility feels unique, it is on par with the long-term average.

Risk Metric	2018	2017	2008	Avg. From 1990-2017
Avg. Daily Trading Range	1.0%	0.5%	2.8%	1.3%
1% or More Down Days	20	4	75	31
2% or More Down Days	10	0	41	9
Plus/Minus 1% Days	41	8	134	63
Max Drawdown	-10%	-3%	-49%	-14%

Source: Cetera Investment Management, Yahoo Finance, and JPMorgan. Data is based on the S&P 500 Index as of 10/24/2018.

Concerns over the Quintuple Whammy are definitely valid; however, we believe there are many reasons to be optimistic about the equity markets for the balance of this year. First, by most measures, such as the labor market, consumer spending, and manufacturing activity, the U.S. economy is very strong. Also, the Atlanta Fed predicts third quarter GDP to grow a robust 3.6%. This followed a 4.2% gain in the prior quarter and represents the strongest back-to-back quarterly growth since 2014.

As we have noted many times, bond yields and interest rates are rising due to strong economic growth. That is a positive thing and we feel the domestic economy can withstand a gradual rise in interest rates. Also, worries about the Fed becoming too hawkish, or raising rates too much, are overblown. Yes, the Fed has recently indicated a slight possibility to accelerate interest rate increases, however, we are confident in Fed Chairman Powell’s continued market friendly strategy of gradually raising rates 0.25% at a time and then gauging the overall impact on the economy. It is a fresh change relative to past Fed leaders. With the Fed suggesting five more rate hikes between now and 2020 and some signs that economic growth may moderate in mid-2020, we do not anticipate the 10-year U.S. Treasury yield jumping dramatically higher from its current level of around 3.15%. This is important as many lending rates are tied to this benchmark.

Strong corporate earnings is another reason to be optimistic for the rest of this year. In general, the consensus expects third quarter earnings and revenues for the S&P 500 to grow 20.2% and 7.5%, respectively. These are both strong numbers so late in an economic cycle. According to Credit Suisse, through yesterday, over 39% of the S&P 500's market cap has reported third quarter earnings. Of these, 77% of these companies have beaten estimates by an average of 4.4%.

Lastly, valuations are in check. Given the recent market weakness, valuations for the S&P 500 have retreated toward more attractive levels. Following yesterday’s selloff, the benchmark equity index is priced at 14.8x next year’s calendar earnings, a level we have not seen in over 2 ½ years. Worries about the Quintuple Whammy are valid and there is a chance that they could worsen. However, we believe underlying economic and market positives should outweigh them. Market volatility will continue to rise as investors sort through these near-term concerns. This recent volatility has clearly shown that, as equities are no longer all moving in the same direction, long-term tested strategies of using active investment management and diversification should be followed. We continue to be cautiously optimistic.

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Glossary

*The **S&P 500** is an index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.*

*The **NASDAQ Composite Index** includes all domestic and international based common type stocks listed on The NASDAQ Stock Market. The NASDAQ Composite Index is a broad based index.*

*The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ*