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Special Bulletin

CORRECTION, REGIME CHANGE, OR SOMETHING MORE OMINOUS?

Recent volatility in the market could fall into one of three scenarios: a garden-variety correction, a regime change tied to a new interest rate backdrop, or the beginning of a bear market. Below, we discuss each possibility and conclude with our outlook.

SCENARIO #1: CORRECTION

The market has not had a significant correction since January of this year, and we anticipated that volatility would be higher for the remainder of the cycle.

In that context, the recent stock market drop could be just another episode of volatility that exists in normally functioning markets—a healthy correction that allows markets to pause and refresh.

With the absence of corporate buybacks, this could be just an air pocket since the largest buyers are out of the market. Corrections are typically about a 10% decline, and we have had about 5% already.

SCENARIO #2: REGIME CHANGE

Another possibility is that the markets are undergoing a regime change. The removal of the word "accommodative" from the Fed's posture on rates signals that a previously supportive Fed is not going to keep propping up the market artificially.

In other words, the Fed has determined that it is no longer prudent to keep policy accommodative and risk asset pricing bubbles, which could be forming. The Fed is therefore giving the market some tough medicine to allow it to function normally without its support.

KEY POINTS

After running through the possible scenarios behind the recent volatility, we attribute the correction primarily to the changing interest rate landscape.

This may be the beginning of a "regime change," which has implications for market dynamics, but does not herald a bear market.

Markets eventually find their footing; do not abandon your long-term plan.

Economic indicators are strong, and rising rates are usually a sign of economic strength, not recession.

Client portfolios are constructed with volatility in mind and should withstand the correction relatively well due to our high-quality equity allocation and overweight to the U.S.

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This, in our view, would herald a healthy regime change in which beneficiaries of low rates might struggle, only to hand off to new leadership with fundamentals (not macro) underpinning market dynamics.

Such regime changes are often associated with elevated volatility while the market churns, settles down, and new leadership drives the market higher. Similar to corrections, regime changes are often about a 10% decline or more, but they sometimes take a little longer to resolve.

SCENARIO #3: BEAR MARKET

Alternatively, this could be the start of something more ominous, such as a bear market. The recent rise in rates, coupled with a fading stimulus and challenges abroad, could conspire to dip the U.S. into a recession, which would cause earnings to drop next year.

In this scenario, not only would markets reset downward due to falling earnings, but the market multiple would compress. A typical bear market with a 20-30% decline could ensue.

CONCLUSION

Our outlook is somewhere between Scenarios #1 and #2. Regime changes are difficult to call while they are unfolding. Considering the backdrop of policy and interest rates, there is a good chance this is something more than a typical correction.

We do not believe this is the start of a bear market, as economic indicators are still quite strong and are not giving us recessionary signals. Therefore, we expect markets will find their footing as soon as the interest rate environment becomes clearer. We expect this to take some time. In the meantime, it is important to maintain a long-term view.

We are not recommending any changes to our portfolios, which are built for this type of volatility. Our portfolio construction anticipates episodes such as the recent market drop, as seen by our allocation to high-quality equity and low exposure to non-U.S. stocks.

Please reach out if we can be of any assistance.

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