

Volatility Returns

- Rising interest rates, and trade tensions between U.S. and China, are the prime drivers of market softness
- The current pullback is confined mostly to stocks; we are not seeing stresses in other asset markets, especially credit
- The near-term future looks less predictable, and volatility is likely to remain elevated, but we don't foresee weakness to be dire or systemic

The stock market has weakened steadily as October has gotten under way, falling some 5% from its all-time high seen just a week ago. While the size, so far, of the pullback remains modest, its swiftness has caused investors to sit up and take notice.

There are a few culprits for the weak action. Foremost is the continuing rise in rates, both in the short end (Fed hikes), and the longer end (market-derived). Yields on long-term U.S. government debt moved quickly higher last week, and higher rates pose competition for stocks as investments. Second, the U.S. and China remain locked in a growing trade war that has seen them level increasingly severe rounds of tariffs on each other's imports. At present, the wrangling over trade and related issues between the two countries shows no sign of getting better.

Even though the near-term future looks less certain, there are still reasons for optimism. Interest rates are moving higher largely on "good" reasons (strong economic growth) as opposed to "bad" ones (spiking inflation and/or a hawkish swing in monetary policy). In prior cycles of interest-rate increases, a 5% yield on the 10-year was a typical yield level for bonds to be stoutly competitive with equities. A similar inflection point today is likely at a lower rate level, perhaps 4%. We believe the market should be able to withstand interest rate competition at levels higher than current.

We are currently on the cusp of third-quarter earnings releases, which should help investors assess business fundamentals. Forecasters expect yet another solid showing this season, helped by corporate tax cuts and higher consumer spending. Operating margins remain high, even with cost pressures ramping up on rising labor costs. We are seeing healthy revenue growth across companies, as well.

The last correction took place earlier this year, in February, following a frothy January combined with fears of a slowing economic outlook. Slowdown fears proved to be unfounded, and the correction turned out to be a buying opportunity for investors who stayed the course. It is impossible to predict the movement of short-term prices. We expect volatility – both to the downside and up – to remain present for a while, and the damage inflicted on investor psychology will take some time to heal. Corrective action in stocks almost always "feels" bad, and it is normal to expect if worse conditions await the investor. Importantly however, the correction has been largely confined to stocks. We are not seeing stresses spreading to other asset markets, most significantly the credit markets. The present pullback has brought the market's valuation closer to long-term averages.

Sentiment can evolve rapidly, but we don't believe the action at present suggests anything especially dire or systemic, and we remain cautiously optimistic.

Respectfully submitted,

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