An October to Forget?

MAKING SENSE OF LAST MONTH'S DROP

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Stock markets around the globe "corrected" in October, experiencing a sudden and broad-based drop. The sell-off was somewhat unusual as there was no glaring fundamental event that triggered the market drop, but rather a confluence of events that all seemed to come to the forefront of investors' minds simultaneously. The largest concern was slowing growth expectations in both Europe and China. The IMF recently lowered its global growth expectations, primarily due to slower growth in emerging markets. China's GDP has also slowed, as the trade war with the U.S. appears to be negatively affecting its economy. Investors have also become concerned about the recent increase in interest rates and flattening of the yield curve. Lastly, there is an overarching concern that the U.S. is late in the economic cycle, and that while corporate earnings growth is strong, third quarter earnings may be as good as it gets. Looking to the year ahead both GDP growth and corporate earnings growth will almost certainly slow from the current pace. These concerns, coming on the heels of a strong third quarter for stocks that left the market looking modestly overvalued, led to an unpleasant month of returns.

As the following exhibits show, the correction was painful and very broad based, affecting all corners of the global equity market. For U.S. equities *(following page)*, it is worth noting that many of the trends prevalent through the first nine months of the year reversed sharply during the correction, and many of the best performing stocks through the first three quarters of the year experienced the largest correction. This can clearly be seen in the relative performance of value versus growth, as value underperformed through the third quarter and sharply outperformed in October. It should be noted that over the last 10 years, each of the following indices is still up over 10% on an annualized basis.

Exhibit 1: U.S. Equity Returns

U.S. Equity Market	Month	3Q	YTD	1 Year	3 Year	5 Year	10 Year
DJ Industrial Average	-4.98%	9.63%	3.41%	9.87%	15.25%	12.76%	13.33%
Wilshire 5000	-7.29%	7.27%	2.47%	6.72%	11.44%	10.98%	13.34%
Russell 3000	-7.36%	7.12%	2.43%	6.60%	11.27%	10.81%	13.35%
Value (Russell)	3.77%	-3.49%	-7.70%	-7.41%	-4.43%	-4.57%	-4.06%
Size (Russell)	-3.79%	-3.85%	-3.27%	-5.12%	-0.64%	-3.04%	-0.99%
S&P 500	-6.84%	7.71%	3.01%	7.35%	11.52%	11.34%	13.24%
Russell 1000	-7.08%	7.42%	2.67%	6.98%	11.31%	11.05%	13.42%
Russell 1000 Value	-5.18%	5.70%	-1.46%	3.03%	8.88%	8.61%	11.30%
Russell 1000 Growth	-8.94%	9.17%	6.62%	10.71%	13.67%	13.43%	15.45%
Russell Mid Cap	-8.31%	5.00%	-1.47%	2.79%	9.04%	8.97%	14.19%
Russell Mid Cap Value	-7.20%	3.30%	-4.30%	0.16%	8.15%	8.11%	13.35%
Russell Mid Cap Growth	-9.90%	7.57%	2.16%	6.14%	10.39%	10.10%	15.10%
Russell 2000	-10.86%	3.58%	-0.60%	1.85%	10.68%	8.01%	12.44%
Russell 2000 Value	-8.95%	1.60%	-2.46%	-0.59%	10.52%	7.18%	10.95%
Russell 2000 Growth	-12.65%	5.52%	1.11%	4.13%	10.72%	8.75%	13.89%

For non-U.S. equities — beyond the reasons mentioned previously — concerns about Brexit negotiations and Italian fiscal policy along with recent German election results that forced Merkel to announce her departure have dragged investor sentiment. Small-cap performance was hurt by Japanese firms, which represent a 30% weight in the EAFE SC index and are down nearly 10% year-to-date. From an emerging markets perspective, Brazil and Qatar were the only bright spots for the month, while China lagged considerably. The MSCI China Index fell 11.5% as a result of the tariff escalations and top Chinese internet companies like Alibaba and Tencent facing downward pressure similar to their U.S. peers. However, similar to the U.S. equity market, the 10-year annualized returns for the major indices are approximately 7% or higher.

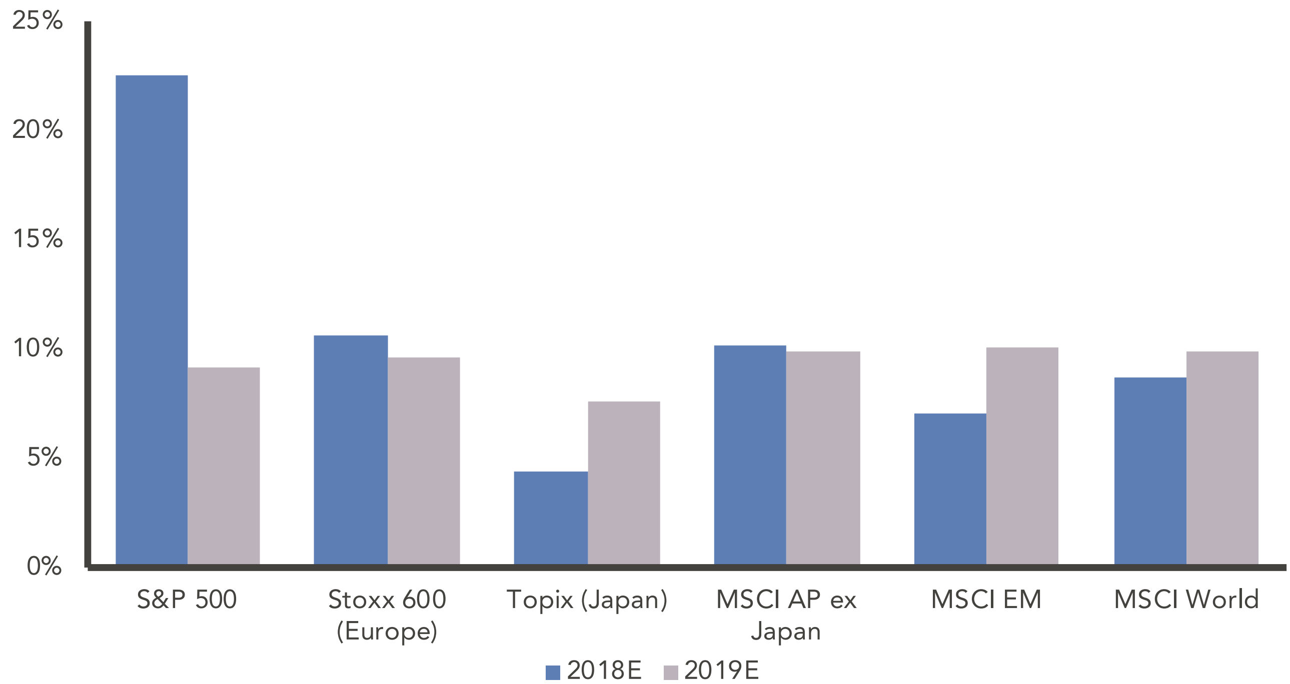
Exhibit 2: Non-U.S. Equity Returns

Non-U.S. Equity Market	Month	3Q	YTD	1 Year	3 Year	5 Year	10 Year
MSCI All Country World ex U.S.	-8.13%	0.71%	-10.97%	-8.24%	4.37%	1.63%	6.92%
MSCI EAFE	-7.96%	1.35%	-9.28%	-6.85%	3.62%	2.02%	6.89%
MSCI EAFE Small Cap	-9.63%	-0.88%	-11.61%	-7.81%	6.58%	5.16%	11.56%
MSCI Emerging Markets	-8.71%	-1.09%	-15.72%	-12.52%	6.52%	0.78%	7.84%

Despite the poor market performance in October, economic fundamentals continue to be strong. GDP grew 4.2% in the second quarter and another 3.5% in the third quarter, the first time we've seen this level of growth in a quarter since 2014. Unemployment remains low at just 3.7% and even the broadest measure of unemployment, which includes discouraged workers and those part time for economic reasons, is at 7.5%, the lowest since 2001. Inflation has been one of the bigger concerns for investors recently, as it has slowly risen over the past few years. But even with this rise, CPI has only grown 2.3% over the 12 months, which is in line with the Fed's target and long-term forecasts. Finally, while there are concerns about the ongoing trade war, U.S. manufacturing also continues to be strong. The purchasing managers index ("PMI") for September was 59.8%, which indicates that the manufacturing sector and the economy as a whole is experiencing robust growth. It is also worth noting that the PMI is above 50 in every major economy across the globe, indicating that economic growth should remain positive both domestically and abroad.

In addition, the third quarter earnings season has been robust. According to Bloomberg, third quarter earnings growth is at 19% for the S&P 500 companies that have reported earnings. Equally important, companies and Wall Street analysts have been revising up their fourth quarter and full year estimates. While growth in 2019 will be slower than 2018 as the positive effects of the tax cut fades, analysts' expectations for growth next year remain in the 8%–10% range. Given the drop in prices but steady earnings expectations, the recent correction has improved equity valuations.

Exhibit 3: Earnings Growth Remains Strong



Source: Goldman Sachs Global Investment Research as of October 29, 2018

Lastly, the bond market has had little reaction to the sell-off in stocks. Historically, there has been significant credit spread widening and a drop in interest rates as investors seek safe haven assets in the lead up to a recession or bear market. This time around interest rates have increased modestly despite the large drop in equities while credit spreads have barely moved and remain tight. Credit investors are not pricing in a significant increase in defaults or a deterioration in creditworthiness. The fact that fixed income markets have shown so little reaction indicates that the recent market correction is more based on valuations and shifting investor sentiment than a deep fundamental risk.

Exhibit 4: Fixed Income Returns

Fixed Income Market	Month	3Q	YTD	1 Year	3 Year	5 Year	10 Year
Core Bonds	-0.79%	0.02%	-2.38%	-2.05%	1.04%	1.83%	3.94%
Bank Loans	0.01%	1.93%	4.36%	4.89%	5.48%	4.19%	7.33%
High Yield	-1.60%	2.40%	0.93%	0.97%	6.60%	4.68%	11.20%
EMD	-2.16%	2.30%	-5.13%	-4.39%	4.33%	4.35%	9.20%

Exhibit 5: Modest Increases to Yield, Spreads Remain Tight

Asset Class	9/30 Yield	10/31 Yield	Change	9/30 Spread	10/31 Spread	Change	Long Term Avg. Spread
Core Bonds	3.5%	3.6%	+0.1%	39bp	44bp	+5bp	69bp
Bank Loans	6.9%	7.1%	+0.2%	381bp	398bp	+17bp	615bp
High Yield	6.2%	6.9%	+0.7%	316bp	371bp	+55bp	586bp
EMD	6.4%	6.8%	+0.4%	335bp	366bp	+31bp	348bp

Market corrections are always difficult to predict and painful to experience, but it is important to put October's performance in context. First, while unpleasant, corrections are not uncommon. Over the past 50 years market corrections (a drop of 10% peak to trough in the equity market) in the U.S. have occurred once every 4 years on average. In addition, investing after months like October has often been profitable. Looking at monthly performance in the U.S. over the last 50 years, the loss of 6.8% puts October's performance in the bottom decile of monthly returns. However, the subsequent 1-year return after those months resulted in a 13.7% return on average, and a 12.2% annualized return on average over the next three years. The average annual return over the same period is 10%. While there are obviously no guarantees, recent history suggests these types of market corrections are not predictive of bear markets and on balance investors have slightly higher than average returns over the subsequent one and three years.

Global equity performance was clearly disappointing in October and many investors are uncertain about the outlook for risk assets in the coming months. While it is impossible to predict the future, Marquette recommends clients take this opportunity to rebalance back into asset classes that have underperformed. The fundamentals of both the economy and corporate earnings remain strong and have shown little deterioration despite the equity market correction. The fixed income markets are not showing any signs of contagion or increased risk. Lastly, history suggests that, on average, risk assets tend to do relatively well after months like October.

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