SPECIAL UPDATE

What's Behind the Market Pullback?

Thoughts on recent market volatility, October 2018

Too much complacency in the market has finally taken its toll, as U.S. stocks sold off sharply during the beginning of October on investor concerns over rising interest rates and the growing trade wars that have started to take a toll on corporations. On Wednesday, October 10, 2018, stocks sank to post their worst day since February of this year, driven by investors selling out of over-valued large-cap Technology stocks and a fear of rising rates. This led to a dramatic change in the YTD performance of the S&P 500 in just a few days, dropping from +10.5% year to date as of 9/30/18 to +3.5% as of 10/11/18. U.S. large cap stocks have not been the only ones impacted by this quick downturn. Year to date through 10/11/18, midcap stocks are down -0.6%, small cap stocks are up only 1.6%, international developed stocks are down -7.5% and emerging market stocks are down a whopping -15.8%. Meanwhile, bonds, which are traditionally the safest component of diversified portfolios are down -2.0% over this same time-period (measured by the Bloomberg Barclays U.S. Aggregate Bond index). In addition, the market is questioning whether what we've seen during October is a panic sell-off or a result of a deceivingly poor economy. All of this creates a challenging environment for asset allocation strategies and understandably causes concern for investors.

A market crash is defined by a 20% loss in the stock market that lasts longer than one year. Over the past 40 years, all but one market crash has coincided with a recession, or a drop in GDP for two consecutive quarters. This is not currently being experienced. To us, this indicates economics are the primary driver of how stocks perform. Consider the following:

1) Market corrections of 5% are very normal and usually occur 3 times on average per year.

2) Current economic data is good and although the trend may tick down as the economy heats up it is still positive. For example, companies within the S&P 500 exhibited earnings growth of about 25% for Q2 2018, 2nd quarter GDP grew at 4.2% (the fastest pace since 2014) and the unemployment rate is at a 49 year low of 3.7%.

3) For all of the tariff talk regarding importing inflation into the country, inflation continues to be tame up only 2.3% on a year over year basis.

Currently, economic data is strong, and the market does not look to be heading for an imminent recession. However, similar to last February, the sell-off has been sharp and is something every investor should be weary of. The recent sell-off in the equity and bond markets, and the volatility in February can be attributed to the longer-term potential of interest rates going much higher. The concern is that this rise in rates would lead to higher borrowing costs for U.S. companies, which would then be passed through to consumers in the form of higher prices. This is one of the first symptoms of a recession, which is not the current environment we're in.

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Quarterly Market Commentary continued …

We believe that the ongoing trade rhetoric has contributed to this sell-off, as companies are beginning to feel the impact of disruptions in global supply chains caused by tariffs. As evidence, the IMF recently downwardly revised its estimates for global growth from 3.9% to 3.7% in 2018 and 2019 as a result of escalating trade tension.

Our view at Klaas Financial Asset Advisors, LLC is that this is a normal market sell-off, especially in the context of previous years in the months leading up to a mid-term election. Even with large cap growth being the main winner this year, our perspective on this sell-off is further supported by the fact that historically, these stocks have not held up leading up to a mid-term election. For example, the Russell 1000 Growth has returned -1.48% on average during the quarter leading up to a mid-term election. This subpar performance leading up to an election illustrates that this sell-off is normal and something we have seen before. Although the looming fears of a trade war remain, current economic data is solid, tax reform is helping earnings of U.S. companies, and interest rates will slowly grind higher based on the expanding economy and a conservative federal reserve.

Looking forward, we believe the solid economic backdrop and clarity from the mid-term election outcome will help asset classes move higher. The market has not posted negative returns in the 12 months following a mid-term election since 1946, and we believe a healthy economic backdrop and continued earnings growth will make this year no different. Though we believe that the fourth quarter will prove to be a strong quarter for domestic equities, we also have positioned the portfolios for volatility, with shorter duration allocations in fixed income as well as allocations to liquid alternatives that should provide downside protection when stocks are under pressure.

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