Market Commentary

October is Living up to its Reputation

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October is living up to its reputation as a scary month for stocks. The 'October Effect' arose because of the events that have occurred in history that are most memorable to equity investors such as the crashes of 1929 and 1987 which both occurred during the month of October.

Global equity markets have experienced a sharp sell-off in recent days leading to a 6% correction in the S&P 500 and a 5% correction in the S&P/TSX in October alone at the time of drafting this note. Recent market action was particularly jarring given the 5% correction in the S&P 500 and the 3% correction in the S&P/TSX in the past two days.

Why is the market selling off?

The catalyst for the market sell-off has been a rapid rise in U.S. interest rates that began post the Fed meeting a few weeks ago, (U.S. 10-year treasury yields rose from 3.06% at the end of September to as high as 3.25% earlier this week). Although interest rates have been on the rise over the past two years, recent activity indicates an acceleration in pace. This has made the equity markets more nervous due to fears around the ability for corporations to digest higher interest rates on their balance sheets.

Economic data has triggered this rise in rates with both a strong ISM non-manufacturing index and the recent drop in U.S. unemployment to a 50-year low, accompanied by a solid rise in hourly earnings. The Fed added fuel to the interest rate fire with additional hawkish commentary implying there was a need to raise rates above the 'neutral' rate, (currently thought to be 3% for overnight rates). The steepening of the yield curve is an indication that a stronger economy is driving interest rates higher.

Is the equity sell-off a normal occurrence?

Yes! This is a normal correction. Equity investors have come to expect lower volatility and consistently rising markets over the past few years because that has been the prevailing environment for equities. Equity corrections of 5% - 10% are a normal occurrence for markets. Equity investing is not without risk and thus should not be viewed that way.

We would characterize this as more of a technical or sentiment driven sell-off than a fundamental or economically driven sell-off in equities. A slight change in policy stance in the U.S. has shifted the fundamentals slightly but economic growth is still robust, (as confirmed by the data), and earnings growth for companies is also expected to be maintained at high levels throughout the next 12 months. A strong economy with strong earnings is a positive backdrop for stocks.

Are we concerned about interest rates?

Higher interest rates do provide a headwind for equity investors in general but context is important. Again the recency effect is relevant – interest rates are high compared with the lows they realized in 2016, but looking back over the past twenty years, U.S. interest rates for 10-year treasuries have spent more time above the 3% level than below it. In addition, given the current 2% inflation level, 'real' interest rates are still quite low at 1%. Similar trends can be observed with Canadian government bonds which are realizing 4 year highs, but still remain historically low at 2.5%.

How are we positioned?

Positioning highlights are as follows:
1. Slight overweight to equities;
2. Slight overweight to US equities;
3. Neutral to underweight Canada/International/EM equities; and
4. Bond duration positioning generally short-mid term.

Are we able to reduce risk for portfolios?

Yes - we can reduce risk but we cannot eliminate risk. Normally in an equity correction, investors seek out safe haven investments which are typically U.S. treasuries, U.S. dollars, Japanese yen and sometimes gold. In this correction, we have not seen the typical rise in U.S. treasuries because interest rates were the catalyst for the correction. This has caused an unfortunate positive correlation, (both asset classes moving in the same direction), in performance between bonds and stocks where bonds and stocks have both experienced negative returns. We expect this correlation to transition to negative, (both asset classes moving in the opposite direction), as investors begin to look at the more attractive yields on risk free government bonds as an attractive place to invest. This will bring some calm to the bond market. In fact we have seen this in the past few days with government bond yields in Canada and the U.S. beginning to retreat.

Our strategic asset allocation reflects a long term view that interest rates are on the rise and thus we are positioned shorter on the yield curve. This has added value as the yield curve has steepened in the recent sell-off. In addition, our utilization of diverse investment styles in all of our major geographies reflects a healthy balance between value, core and growth styles. While the value styles have been perennial under-performers in the recent market run-ups, we expect these strategies to now have their day in the sun as the higher valued growth sectors are more susceptible to market contractions due to their over-owned (and high priced) status across portfolios.

Our exposure to alternative asset classes also provides the opportunity for uncorrelated returns to offset when equity and bond markets highly correlate in one direction. While this may be a drag on performance in strong up markets, these strategies are intended to earn their place when the market environments are less favourable, ultimately smoothing out returns.

Other Resources:

Please see my interview with Catherine Murray on BNN Bloomberg from October 10th 2018 (via the link below) where I discussed some of the above points.
https://www.bnnbloomberg.ca/video/what-s-behind-the-market-selloff~1510437