Reflections on a Red October

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LOTS OF QUESTIONS HAVE SWIRLED AROUND THE HORRIBLE PERFORMANCE OF RISK ASSETS IN OCTOBER. Have corporate earnings peaked? Are markets adjusting to higher interest rates? Was this an overdue correction? I think the answers are yes, yes, and yes.

In my view, the market is calibrating specifically to three things:

1. The slowdown in the pace of global growth, which could start to show up in weaker earnings;
2. The 0.40% rise in 10-year US Treasury yields between the end of August and beginning of October; and
3. Overbought conditions in cyclical sectors, particularly technology.

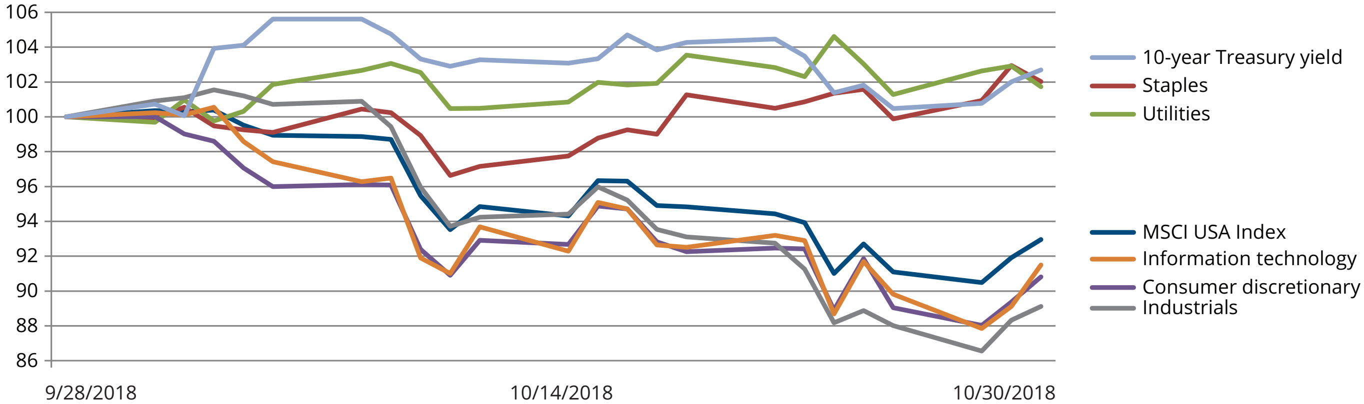
I maintain that the economic slowdown is modest and starting from healthy levels. Recession risk remains low, so there is little need for investors to panic. That said, recent sector performance may give us some important clues about the future.

FIGURE 1 shows the bifurcated performance of cyclical and defensive sectors over the past two months. Consumer discretionary, industrials, and information technology—all cyclical sectors—performed the worst relative to defensive areas, such as consumer staples and utilities.

Key Points

- Despite the weak performance of risk assets in October, the economic slowdown is modest, and recession risk remains low.
- Slowing global growth may encourage investors to evaluate their equity risk.
- Defensive sectors could potentially outperform in a lower-growth environment.

FIGURE 1
Bifurcated sector performance
MSCI USA Index[1] sector performance, US 10-year Treasury yield, indexed to 100 on 9/28/18



As of October 31, 2018 | Source: Bloomberg | Past performance is not guarantee of future results. Investors cannot directly invest in an index.

[1] MSCI USA Index is a free float-adjusted market capitalization index that is designed to measure the performance of the large and mid cap segments of the US market.

Curiously, the outperformance of defensive sectors occurred despite the rise in 10-year yields that began in late August. This seems counterintuitive given that these sectors are often considered bond proxies because of their typically steady cash flows and relatively high dividends.

My take on this dynamic is that the market isn't just concerned with higher interest rates; it is also worried about—and starting to price in—slowing global growth. Investors may have sold cyclicals, which have performed well in recent quarters and appear overbought, in anticipation of that trend. I think it is prudent to consider reducing equity risk at this point by rotating into more defensive sectors.

Investment Implications

Consider maintaining an overweight to equities relative to bonds, but focus equity exposure in less risky regions, such as the US, over other developed markets and emerging markets.

Within cyclicals, consider thinking about rotating away from expensive areas, such as consumer discretionary, industrials, and IT, into cheaper areas, including financials and energy.

Consider adding defensive sectors, such as consumer staples, healthcare, and utilities, that could potentially outperform in a lower-growth environment.

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