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MacLean Capital Advisors

***Rates rise and China slides: Making sense of the market sell-off***

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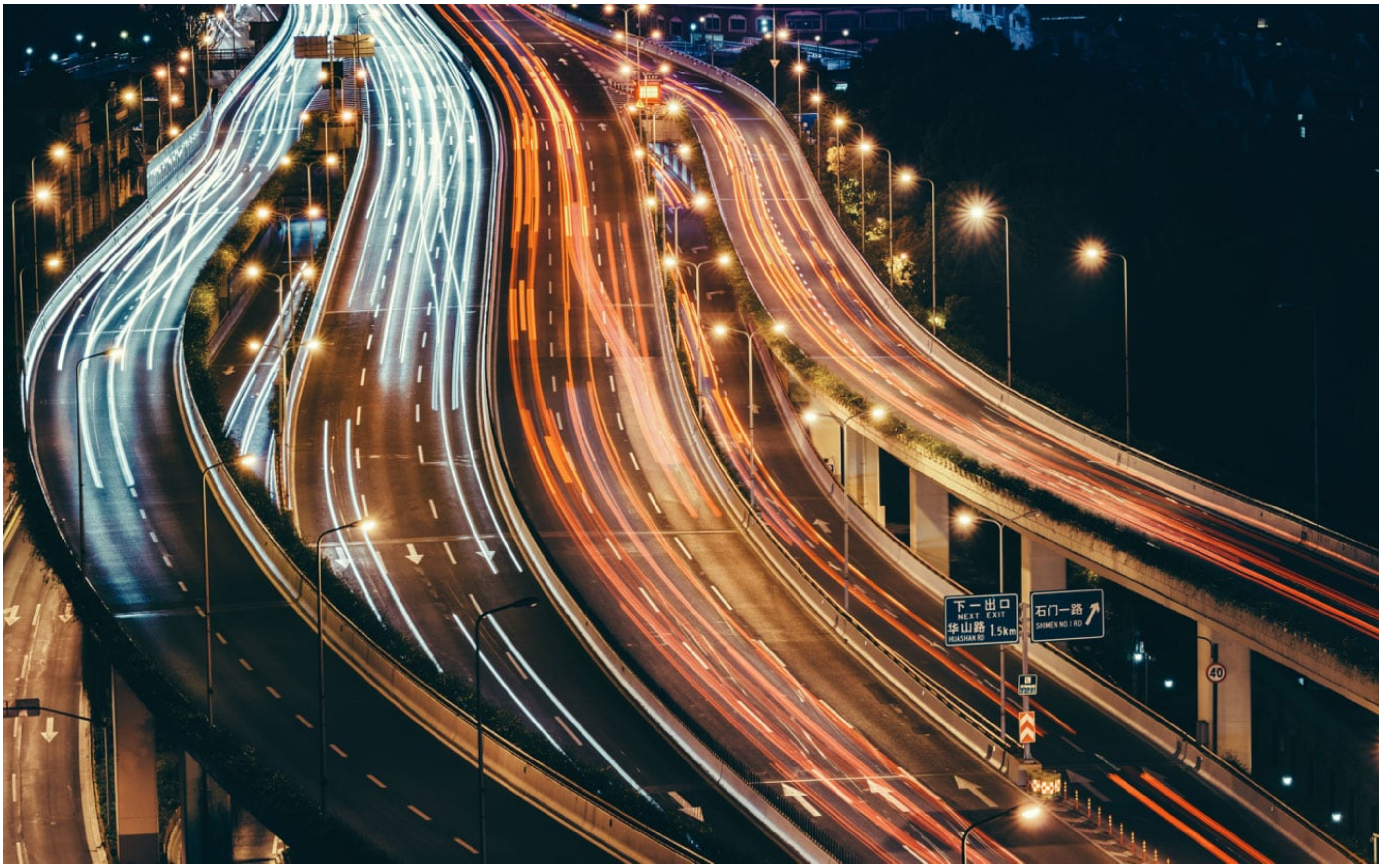



INVESTMENT PERSPECTIVES

# Rates rise and China slides: Making sense of the market sell-off

Upended by rising Treasury bond yields, global stocks have declined sharply in recent days as investors grapple with concerns over tighter U.S. monetary policy, a brewing trade war and slowing economic growth in China. The selloff has been led by declines in the shares of technology companies, including many of the names that consistently drove equity markets to new highs during a nearly decade-long bull market.

“The stock market pullback is not particularly surprising, when you consider that rates are rising, the labor market is tight and the Federal Reserve is removing some liquidity from the system,” says Capital Group economist Darrell Spence. “Equity valuations were also elevated, and the market had been underestimating what the Federal Reserve said it was going to do in terms of increasing short-term rates. And there is a trade dispute with China that could put further pressure on the economy.”

Indeed, investors should expect more volatility ahead as we approach several potentially market-moving events, including: the U.S. mid-term elections, further Fed tightening and the withdrawal of crisis-era stimulus measures by the European Central Bank. We see five reasons that could continue to spur market volatility:

**1. Rising rates are putting pressure on equities.**

U.S. equities may have been due for a correction, but part of the answer lies with the bond market. The rapid rise in rates in recent weeks was the immediate trigger. It is not so much the direction that has surprised markets as much as the pace of the bond market reaction, with the 10-year bond yield touching a high of 3.23% and the 30-year bond yield hitting a four-year high of 3.40%.

**Stocks and 10-year yields have seen big movements recently**


*Sources: Standard & Poor's, Thomson Reuters. As of 10/11/18.*

**2. U.S. monetary policy is no longer accommodative.**

That's sparking market volatility through a combination of rising rates and the end of quantitative easing. There will be continued tightening as long as the pace of economic activity remains elevated and inflation expectations are rising. "As the Fed moves from quantitative easing to tightening policy, it is more data dependent in its timing," says Mike Gitlin, Capital Group's head of fixed income.

What the data tells us today is that the U.S. job market is very strong: the unemployment rate hit a 49-year low of 3.7% in September. And U.S. inflation has risen above the Fed's 2% target, with the year-over-year Consumer Price Index hitting 2.9% in June and July, the highest clip since 2012. Those are the two most important factors that the Fed considers when deciding whether or not to raise rates. And they indicate that the Fed is likely to continue hiking rates into the foreseeable future. Our fixed income team expects an additional interest rate increase in

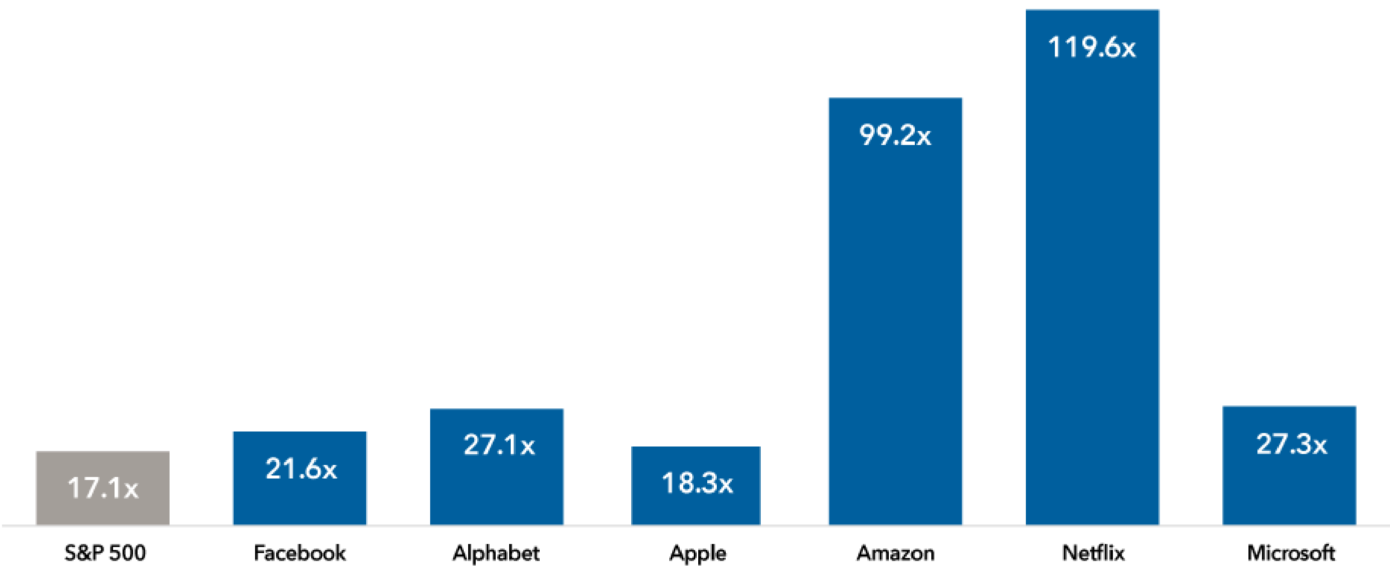
December to 2.5% with an additional two or three more hikes likely in 2019.

**3. The pullback in technology should not be a surprise.**

Technology has risen to become 26% of the S&P 500 index and if you throw in Netflix and Amazon, the weight is closer to 30%; these companies have had an outsized effect on market indexes – in both directions.

Also keep in mind that the technology sector gained 22% year-to-date and soared more than 600% since the end of the last bear market. Technology stocks typically trade at a premium to the overall market, due to their outsized growth potential. With that in mind, stocks such as Facebook, Microsoft, and Alphabet have price-to-earnings (P/E) ratios in the 20s, based on 2018 estimated earnings by data aggregator FactSet. These are high, but not excessive. Even stocks with very high valuations, such as Amazon, appear more reasonably-valued when using a revenue-based metric. For example, on a price/sales ratio, Amazon has the lowest ratio of any FAANG stock (Facebook, Apple, Amazon, Netflix and Alphabet's Google), and more in line with the overall market.

**Valuations of many technology companies look reasonable despite recent climb**




*Sources: FactSet, Standard & Poor's. As of 10/11/18. Earnings component of price-to-earnings ratio are full-year 2018 estimates, provided by FactSet.*

**S&P 500 Index earnings growth estimates**

| 3Q18 | 4Q18 | CY 2018 |
|---|---|---|
| 18.9% | 17.0% | 20.2% |

*Sources: FactSet, Standard & Poor's. As of 10/11/18.*

**4. We may be seeing some early fallout from the trade skirmishes with China.**

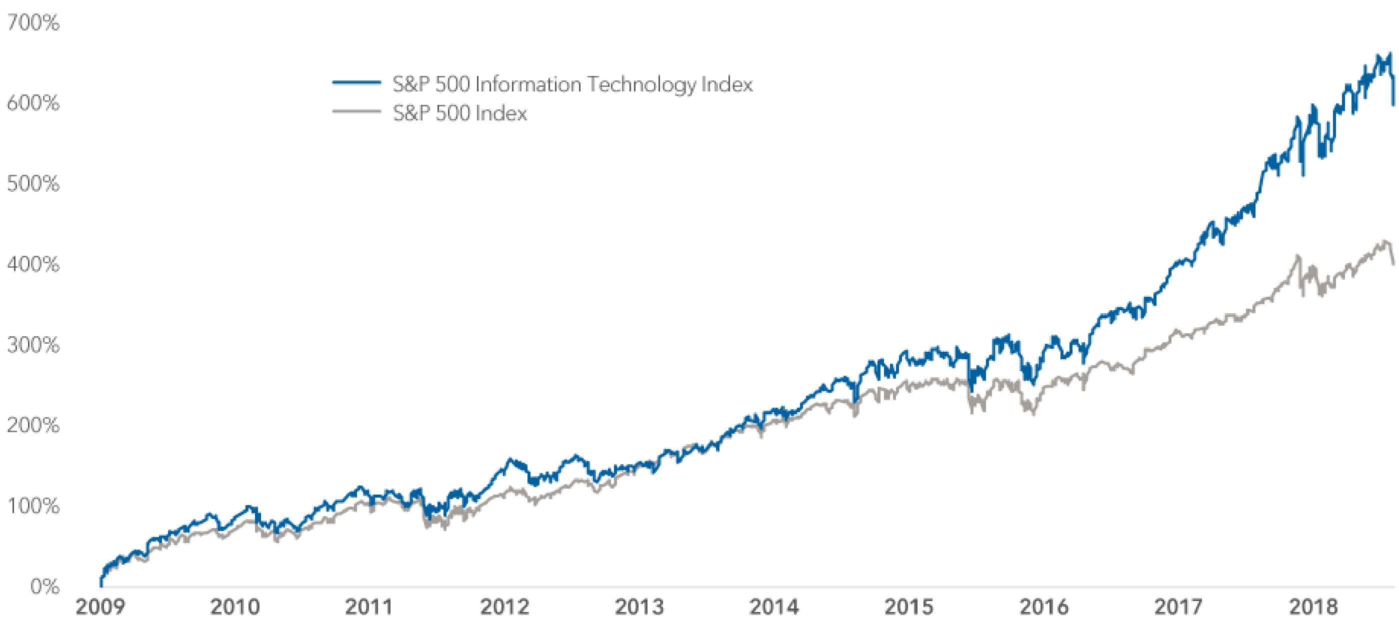
Earnings season is upon us and while there haven't been many hard data points, there were a few disappointments: PPG Industries and Fastenal, two industrial companies referenced slowing China demand.  LVMH, a French luxury goods company, also noted ramping up of border checks on returning travelers and a weaker Chinese consumer. While these are early data points, they may be pointing to a potential trend.

**5. Growth is slowing more than expected in China and Europe.**

China's economy in the second quarter grew at 6.7%, the slowest pace since 2016, leading to fresh stimulus measures from Chinese authorities. Europe's economic growth rate has slowed for the third quarter in a row.

Despite a late economic cycle, some positive factors persist.  Although we are in the late stages of the economic cycle in the U.S., we have seen steadily rising profit margins, relatively low interest rates leading to low cost-of-borrowing, muted inflation in wages or commodities and reduced income taxes. These have created a positive tailwind which will diminish moving into 2019 but is unlikely to reverse. It does, however, point to more modest return expectations.

**Cumulative S&P 500 return since 2009 trough**




*Sources: FactSet, RIMES, Standard & Poor's. Latest data point reflects intraday value on 10/11/18.*

"The market has been rising for nearly 10 years, so higher volatility at this stage should be expected," says portfolio manager Alan Berro. "A 10% or 15% correction can happen any time for any reason. But do I expect a severe downturn, a deep recession or a global crisis coming? There is nothing I see out there today that leads me to that conclusion."

For a full-fledged bear market to ensue, the economy needs to go into reverse. Our economists don't expect that for some time. "We are late in this cycle but the economy is still growing strongly in the U.S. Earnings are slowing from peak levels but still strong by historic standards. The U.S. economy remains healthy and despite the tightening labor market, inflationary pressures appear to be relatively mild. And there are no obvious imbalances that might trigger a recession in the short term. So I expect the U.S. expansion to continue into next year," says economist Darrell Spence.

**In volatile periods like this, investors should be sure to have a broadly diversified portfolio.**

Investors should have a buffer of liquidity and sufficient diversification away from equities in their bond portfolios. Asset allocation is important and helping clients understand how to navigate this environment will be crucial. In these periods, investors can benefit from:

- Maintaining a broadly-diversified portfolio.
- Having a portion of their portfolio in liquid assets, such as cash and high-quality bonds.
- Making sure at least a portion of their fixed income allocation provides diversification from equities.
- Having a balance between growth and dividend-oriented strategies in their equity allocation.

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