

Institute Alert

NEWS OR EVENTS THAT MAY AFFECT YOUR INVESTMENTS

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Five Key Risks for the Equity Market

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Key takeaways

- » *The sell-off that started in October has resumed recently after a brief respite in early November.*
- » *The economy still appears solid, and we believe this is not the end of the economic cycle or the bull market.*

What it may mean for investors

- » *We believe investors should continue to fight the urge to overreact to negative headlines and instead focus on implementing their investment plans. We also recommend considering increasing equity exposure selectively, especially by deploying cash.*

The sell-off that started in October has resumed recently after a brief respite in early November. A variety of factors are bothering markets, and this report considers the main influences and what investors may want to focus on:

1. **Trade war** – Further U.S.-China tensions at the recent Asia-Pacific Economic Cooperation summit led market participants to dial down their expectations for the upcoming G-20 meetings later this month. A deal on trade is more likely in early 2019, but probably not until after another round of tariffs is implemented. That being said, we don't believe a full agreement is needed at this time, but a high-level understanding and a handshake between the two countries' presidents to resume talks and not escalate tariffs further would be a good first step.
2. **Fed tightening** – One of the main market concerns is that the Federal Reserve (Fed) will make a policy mistake by raising interest rates too fast. This difference of opinion in how quickly to raise interest rates can be seen in financial markets, which expect only two hikes in 2019, while the latest survey of Fed policymakers suggests four potential hikes. However, recent Fed speakers have already softened their tone a bit, but markets seem unable to give them the benefit of the doubt. We believe investors may see in the coming months that the Fed is not on autopilot and won't exceed the neutral rate blindly—instead, it will stay flexible and data-dependent.

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3. **Oil price declines** – Crude oil’s slow and steady ascent during the first nine months of 2018 and the subsequent crash over the last six weeks is one of the more remarkable market reversals this year. Investors are concerned that the price of oil might point to a global growth slowdown. We believe that much of the decline was due to oversupply, rather than slowing demand, and that a price rebound is likely. The stability we foresee in the price of oil should further help to repair sentiment. The December 6 OPEC (Organization of Petroleum Exporting Countries) meeting is an important catalyst for oil markets, although we believe Saudi Arabia is capable of balancing 2019 oil markets on its own.
4. **China slowing/global slowdown**– China’s economy has been slowing this year, mainly from the impact of financial reforms. As China showed in 2015-2016 during its last round of significant reforms, the government is committed to economic stability, and willing to provide stimulus if growth slows by too much. The current slowdown is less extreme than in 2016, but Beijing has already implemented a wide range of stimulus measures: a weaker currency and various measures to spur bank lending. Beijing also could rein in the reforms, if necessary. However, markets may remain uneasy until China’s stimulus measures gain traction (probably early in 2019).

Meanwhile, European political problems are creating new stress. If Britain’s parliament approves a proposed Brexit deal in early December, markets could see significant relief; a failed vote in parliament would add to market worries. Italy’s budget challenge to Brussels also is likely to become noisier in the coming weeks.

5. **Technology selloff** – Recent earnings reports and cautious guidance about future business prospects have caused an abrupt selloff in Technology. Also, concerns over extended valuations, more regulatory scrutiny/oversight, and peak earnings growth have created a difficult near-term outlook for many tech companies. The sharp decline in valuation multiples during the pullback should lessen some of the concerns about valuation and the worst of the sell-off may be over.

We still see a solid U.S. economic outlook—just in the last week we have seen good data on small business optimism, consumer confidence, retail sales, and industrial production. But concerns about a global growth slowdown are pulling down strong U.S. growth and investor sentiment. Still, the bottom line, in our opinion, is that an economic recession is not imminent—even as many areas of financial markets are pricing like we are heading for one.

When market sentiment turns so negative, stock price levels make a difference in the near-term outlook. We would become more concerned if the S&P 500 Index breaks below price levels that have been supports during selling episodes earlier this year. Those important support levels include the October 2018 lows (2640-2655) and the lows from the first quarter of 2018 (2581-2605).

What should investors do now?

Keep perspective: We believe investors should continue to fight the urge to overreact to negative headlines, and instead, focus on implementing their investment plans, which should include asset allocation, diversification, and rebalancing as core components.

Look for opportunities in equities: As we wrote in October, market action this year probably marks the end of the unprecedented period of low volatility and above-average returns across equities, fixed income, and currencies.¹ Yet, the economy still appears solid, and we believe that this is not the end of the cycle or the bull market. We view now as a time to be ready to increase equity exposure in favorable areas, such as U.S. large-cap, U.S. mid-cap, and emerging-market equities, and favor deploying cash now—or even allocating incrementally over the coming days and weeks. In our opinion, current conditions have the potential to create some of the best entry points into equity markets since the November 2016 elections.

¹ Please see our report, *Institute Alert*, “Opportunity Amid the End of Easy,” October 15, 2018.

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