Key Investment Perspectives

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Global equities

Volatility returns with a vengeance

United States

The month of October saw the broad US equity market, as measured by the Russell 3000 index (-7.4%), record its worst monthly performance in seven years and its second worst month since the throes of the global financial crisis a decade ago. As usual, the press is replete with myriad reasons for the downdraft – slowing global economic growth, rising interest rates, trade wars, earning misses, cautious outlook by some prominent technology companies, peak valuations, and peak profitability. Some politicians have even argued that October's market selloff was a harbinger of the gridlock that would ensue in a divided government, with Democrats taking control of the House of Representatives after the US midterm elections.

With the exception of the idiosyncratic earning shortfalls, these narratives have been known for months. Even then, there are counterarguments for several of them. The US economy continues to strengthen, and the unemployment rate remains at multi-decade lows. US companies are growing and exceeding earnings estimates at an above-average clip, perhaps justifying their valuations (which have come in lately). Interest rates barely nudged, with the 10-year treasury ending October up only 6 basis points (BPS) despite rising 14 BPS at one point during the month. Also, consumer confidence increased in October to levels last seen in the fall of 2000. Lastly, speaking of the midterm elections, the initial market reaction to the Democrats taking back the House after eight years has been positive. We believe that there are times when the reasons for market gyrations can be precisely attributed; other times, the catalysts are not so obvious. Benjamin Graham put it aptly: "the market is a voting machine, where on countless individuals register choices which are the product partly of reason and partly of emotion." We will chalk October up mostly to the emotion column.

As with risk-off months, sectors with defensive characteristics like Consumer Staples (+2.3%) and Utilities (+2.0%) acted as safe havens, while highly volatile sectors like Energy (-11.3%) and those with strong recent price momentum like Consumer Discretionary (-11.3%) witnessed heavy selling. We highlight this performance dispersion below.

October Market Data

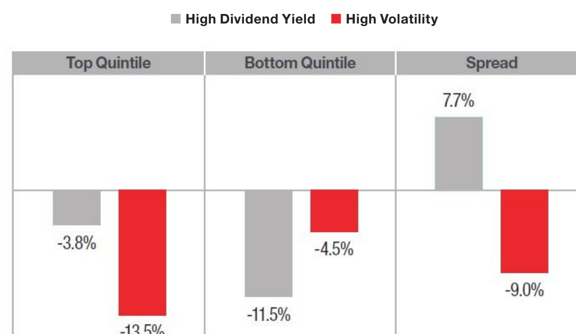
	1 Month	3 Month	YTD	1 Year
US Equity All Cap	-7.36	-3.95	2.43	6.60
US Equity Large Cap	-7.08	-3.51	2.67	6.98
US Equity Small Cap	-10.86	-9.26	-0.60	1.85
US Equity Large Cap Growth	-8.94	-3.43	6.62	10.71
US Equity Large Cap Value	-5.18	-3.59	-1.46	3.03
US Equity Small Cap Growth	-12.65	-9.39	1.11	4.13
US Equity Small Cap Value	-8.95	-9.10	-2.46	-0.59
Developed International	-8.20	-9.20	-8.90	-7.60
Int'l Emerging Markets	-8.99	-12.15	-16.45	-13.02
Global Treasury	-0.89	-2.10	-3.32	-1.72
US Investment Grade	-1.46	-1.33	-3.76	-3.02
US High Yield	-1.60	-0.32	0.93	0.97
Real Estate	-1.76	-1.63	0.45	3.09
Commodities	-5.84	-1.09	5.31	11.47
Municipal Bonds	-0.62	-1.01	-1.01	-0.51

Sources: S&P GSCI, Russell, Barclays, Key Private Bank

Key Private Bank

Not unexpectedly, value stocks (-5.5%) had their best monthly showing relative to growth stocks (-9.2%) in a decade. Despite the 3.8% return differential, growth stocks are still outpacing value stocks by almost 8% year-to-date, so we will caution that one month does not a trend make. We continue to maintain a neutral stance in the value-growth debate, as our models view both as nearly equally attractive over the next 12 months. Lastly, large cap stocks (-7.1%) outperformed small cap (-10.9%) by the same margin (3.8%) as the value-growth spread. Nevertheless, we remain neutral with regards to market capitalization. It is, however, instructive to note how both value and small size – two hitherto reliable factors for harvesting excess return – have defied conventional logic and disappointed investors over the last decade. There are indeed no free lunches.

Russell 3000 Best and Worst Performing Factors in October 2018



Source: S&P Capital IQ and Key Private Bank

Developed ex-US

International markets were not sparred from the October jitters, as the Russell Developed ex-US index fell by 8.7%. A variety of macroeconomic factors were at play, which included disappointing Eurozone PMI data, slightly softer German business confidence data, and weaker third quarter Eurozone GDP growth. Political factors were also an influence, with the EU's rejection of Italy's draft budget, Moody's subsequent debt downgrade, uncertainty surrounding Brexit as the March 2019 deadline approaches, and Angela Merkel's decision not to run as party leader in December. The confluence of these issues made October the worst month in seven years for international markets. Similar to the US, small cap stocks (-9.5%) underperformed larger cap stocks (-8.0%), while defensive sectors outperformed.

The euro weakened by 2.6% relative to the US dollar as the European Central Bank (ECB) held interest rates steady while reaffirming the end of the asset purchase program by December. There are concerns in some quarters that the ECB would now have very limited arrows in its quiver in a recession scenario given how low interest rates currently are. We would however argue that the ECB's quiver, although limited, is by no means empty. There are non-standard monetary policy tools like the TLTROs (Targeted Longer-Term Refinancing Operations) where the ECB would provide long-term loans to banks to incentivize them to increase lending to businesses and consumers. TLTROs were used in 2014 and 2016. The ECB could also restart the asset purchase program if needed. Lastly, the forward guidance on the level of the policy interest rate is such that the ECB would keep rates at the current levels "at least through the summer of 2019," and for much longer if needed. That said, we do view risk is the downside as evidenced by recent weakness in hard and survey data. Thus we maintain a slight underweight to developed equities ex-US in favor of emerging markets.

Emerging markets

The bloodbath in emerging markets continued in October, declining another 9% to bring year-to-date returns to -16.5%. For a change, they had company as the global equity markets cratered in unison. Rising interest rates and continued tensions from the US-China trade war exacerbated a synchronized selloff across markets. Mexico was the worst performing market, down 17.2%, representing the country's worst monthly performance since the global financial crisis a decade ago. Investors did not take kindly to the new government's decision to cancel the partially built airport in New Mexico City. In addition, the peso fell almost 8% against the US dollar, induced partly by fears of rising inflation. However, Latin America also had the brightest spot in emerging markets, with Brazil defying the global equity market malaise by registering a very healthy 18.9% return. The market was buoyed by investor optimism that right-wing presidential candidate (now president-elect) Jair Bolsonaro would implement market-friendly policies and relieved that there was finally an end to the corruption-tainted PT party that had held a stranglehold on Brazilian politics for over a decade. The Brazilian real also rallied by 7.8% against the US dollar. Outside Latin America, China (-11.5%), South Korea (-14.3%), and South Africa (-10.9%) were all big losers. South Africa is now down 30% year-to-date, with over half of that loss attributable to the rand's 16.2 decline against the US dollar.

We acknowledge that emerging markets may face increased outflows in the short term, but we believe the year-to-date underperformance may be overdone. We submit that the equity markets of developing countries with superior growth prospects, improving balance sheets (e.g., less indebtedness), and demographic dividends are likely to outperform over the long run. Hence, we are maintaining a slight overweight to emerging markets.

Fixed income

Earning their diversification keep

Most broad US fixed income indices had mildly negative returns in October, benefiting in part from the risk-off sentiment. Thirty-year treasury bonds, however, were the worst performing segment, down 3.64%, after yields rose by 20 BPS from 3.19% to 3.39%. The popular Barclays US Aggregate Bond Index was down 79 BPS, while US Investment Grade, US High Yield, and Emerging Markets were down 1.5%, 1.6%, and 1.8% respectively.

Credit spreads widened slightly across the board, reflecting some level of investor apprehension. The option-adjusted spread (OAS) on the Barclays US Corporate High Yield Index widened the most, rising from 309 BPS to 371 BPS. This spread is however significantly below the average OAS of 508bps since 1994. With default rates unsustainably low and historically tight credit spreads, we believe high yield bonds are one of the least attractive segments of the fixed income market.

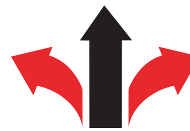
Overall, fixed income markets provided some level of diversification, despite also registering negative returns, in an otherwise tough market environment for risk assets. While we remain positive on equities and have an underweight to fixed income, their defensive attributes should come in handy during risk-off periods like October.

Alternatives

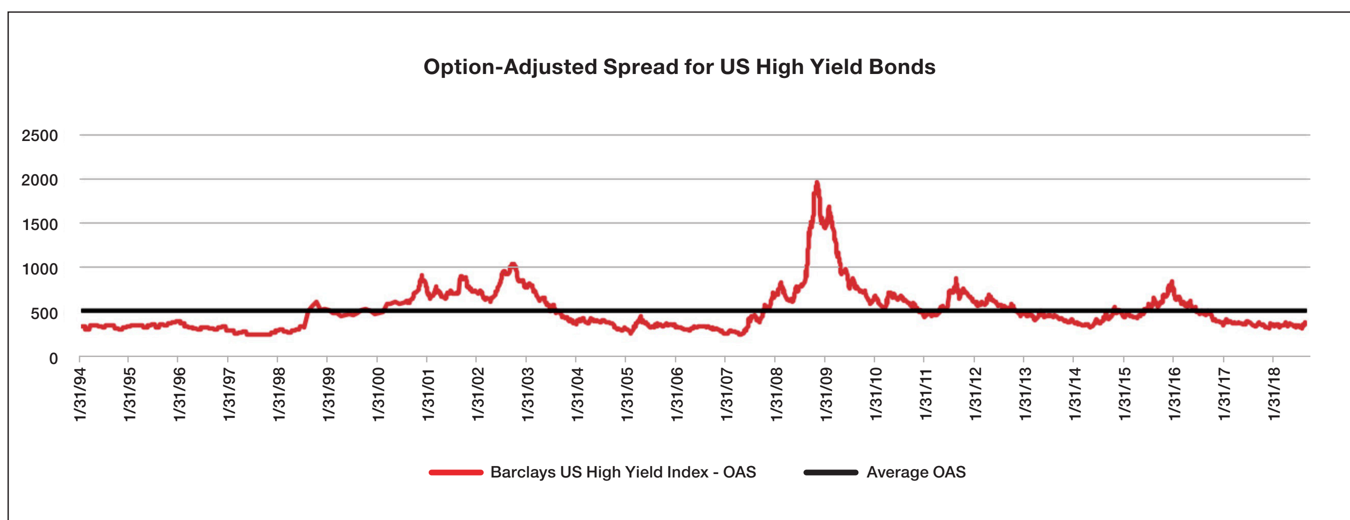
Hedge funds and real estate hold relatively steady, but no relief from commodities

Hedge funds, measured by the HFRX Equal Weighted Index, were down 2.2% in October, providing some level of diversification. Relative value strategies (-1%) were the best performing segment, while event-driven (-4.6%) and equity long/short strategies (-4%) were the worst, owing to their beta exposure to equity markets.

US REITs were down by 1.8% with retail (-0.2%) being the best performer, while hotel and lodging REITs (-10.2%) were the worst performing segment.



Commodities were mixed, with losses in crude oil (-10.5%) and nickel (-8.7%), partly offset by gains in agricultural products like sugar (18%), coffee (10.2%), cocoa (8.8%), and safe haven assets like gold (1.8%). The S&P GSCI All Crude Index, although still up 16% year-to-date as of month-end, has now declined from its year-to-date peak of 34% in less than three months. A slowing global economy and OPEC's expectations for increased crude oil production over the next five years are some of the reasons for the recent slide.



Source: Bloomberg Barclays Indices

Tactical asset allocation

Cautiously overweight equities

Key Private Bank's tactical asset allocation recommendations are based on three pillars – corporate fundamentals, macroeconomic insights, and investor psychology. Corporate fundamentals capture the long-term impact of valuation and profitability across various asset classes. Macroeconomic insights capture the impact of leading and coincident economic indicators as well as broad market variables like currency, inflation, and interest rate. Investor Psychology attempts to capture aspects of investor behavior that are not necessarily driven by fundamentals, as well as the views of informed market participants like hedge funds, equity analysts, and credit analysts. Based on these factors, we currently recommend an overweight to equities and an underweight to bonds. Within equities, we maintain a slight overweight to emerging markets and are neutral across all other regions, size, and style.

For more information about how the market climate is impacting your portfolio, contact your Key Private Bank Advisor.

About the Author

Bola Olusanya has more than 20 years of experience in investment management as both an executive and thought leader. As Managing Director of Asset Allocation and Portfolio Strategy with Key Private Bank, Bola applies his expertise to direct Key Private Bank's third-party manager research efforts, oversee the group's portfolio construction efforts, and design an asset allocation methodology applicable to all stakeholders.

Bola received an MBA with a concentration in finance from Emory University and an MS in computer science from the University of Lagos. He is known for his quantitative expertise, his extensive knowledge of the full spectrum of asset classes, and his ability to mentor and manage high-performing investment teams.

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