

## SYNCHRONIZATION OF RISKS

Market Review    MAY 2019

Stock indexes retreated last month on increased global tensions and uncertainties. The index level on the S&P 500 dropped in May posting its worst monthly loss since December of last year. Still, the index level maintains a high single digit lead on the year.

The global stock sell-off began when the US announced that it would soon impose higher trade tariffs on China. Investors became skittish when the news broke due to the consequential impacts that higher tariffs can have on the highly integrated supply-chain that is China. Investors need to look no further than the recent damage that was done in stocks of semi-conductors and technology companies to see the toll that a trade disruption can have on large American firms. Those stocks were widely market leaders before the trade tensions broke once again, but reversed into major market losers shortly thereafter.

More broadly speaking, the investing community is still highly concerned about a global growth slowdown. In fact, recent manufacturing survey data regularly released by the Purchasing Managers' Index (PMI) provides such evidence. For instance, the PMI data of large economies have slipped lower over the course of a year. Although, none of the PMI indexes of major global economies are showing contraction readings as of yet, one particular PMI to watch closely is China's.

Chinese growth is likely slowing and the risks present in its economy are probably not improving. For one, unofficial and non-traditional data sources would indicate that economic activity in China is much lower compared to what the official statistics would otherwise have someone believe. China may also be at risk of losing control of its currency peg due to a depleting supply of foreign exchange reserves and an inability to quickly raise a new supply of reserves. Should the Chinese currency slip, China could be forced to look inwards for growth, which would place greater pressure on its ability to sustain and create new growth.

Today's more cautious investors have at last synchronized global stock exchanges around the world. This time around seems different from the same time period last year. In the prior year, US stocks were on the rise while foreign stocks were being sold. US and foreign stocks finally synced up somewhere around the fourth-quarter of last year and have remained so

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since. For example, foreign stocks experienced similar losses that nearly matched the S&P 500's losses in May.

The global bond markets and stock markets would appear to agree regarding today's outlook on global growth. Global yields on government debt have fallen in most major economies. Benchmark yields on Japanese and German debt have retrenched back into deeper negative territories, which means people are willing to pay governments for the opportunity to lend to them! This should only happen in a scenario where future price trends will turn deflationary.

More specifically, the US government can currently borrow for ten-years at a cost that is below borrowing for one-year or less. This means that the borrowing rate between borrowing for ten-years and one-year is inverted. Two factors are likely at work here. One, the market is setting expectations that US nominal growth will eventually move lower. The second is the bond market is voting that the Federal Reserve is finished with raising rates and may end up cutting rates in response to slowing growth.

The inverted yield curve has made some investors holding US assets more jittery. Typically, it's common to see a recession after the yield curve has been inverted for a long enough period of time. Still, it's not uncommon to experience equity market rallies when there is an inversion of yields on government debt. The estimate of future growth is a critical input for pricing financial assets. When estimates become ever so more uncertain so will the prices on financial assets. The end result is higher volatility in asset prices and opportunities for investors that are prepared with a prudent risk management strategy.

## Market Movers

Last month was an exemplary representation for the meaning of “sell in May and go away.” Defensive actions made by market players came back in season even if their trades are only short-lived. For once in what feels like a long while, the correlation between riskier and defensive assets fell into a deeper negative relationship. This bodes well for investors holding highly diversified portfolios. In actuality, this year may turn out to be the year where diversified portfolios show their true value and outperform portfolios that are piled into growth. Our Core Allocation portfolios provide such diversification and other methodologies that strive to effectively manage risks. We’re seeing healthy growth in our portfolios this year and experienced attractive performance in May relative to the broader stock markets.



**US STOCKS** experienced the greatest losses in May according to the category-averages. Riskier stock asset classes like mid- and small-caps saw losses in excess of the losses recorded on large-caps. For the year, all US stock category averages are holding high single-digit leads. This year’s performance on large- and mid-caps are tracking closely together and small-caps are the sole outlier, which are underperforming the US stock category average.



**FOREIGN STOCKS** followed a similar pattern of losses in the prior month. All categories representing foreign stocks recorded similar one-month declines. Both large- and small-cap stocks in developed economies lead in terms of relative performance this year. Emerging market stocks have underperformed developed markets and the gap seems to be deepening. Still, performance in emerging markets is positive for the year with mid-single digit gains.



**US BONDS** saw money flow in as money poured out of stocks in May. The category booked the greatest gains in bond assets of lesser risk. US treasuries led in the month and gains even showed up in high quality corporate bonds. Last month’s biggest loser was in high-yield corporate bonds. For the year, higher and lower quality types of corporate bonds sit on top of the bond leader board.

## Asset Categories

## Monthly

## YTD

<b>US STOCKS</b>	<b>-7.05%</b>	<b>9.40%</b>
<b>FOREIGN STOCKS</b>	<b>-5.47%</b>	<b>6.93%</b>
<b>US BONDS</b>	<b>0.49%</b>	<b>5.34%</b>
<b>FOREIGN BONDS</b>	<b>0.37%</b>	<b>4.70%</b>
<b>HARD ASSETS</b>	<b>-3.49%</b>	<b>9.97%</b>
<b>HYBRIDS</b>	<b>-1.74%</b>	<b>9.26%</b>

\*DATA USED IS SOURCED FROM MORNINGSTAR®, DATE ENDING MAY 30, 2019.



**FOREIGN BONDS** provided modest returns in the previous month. Developed market bonds outperformed emerging markets in May. But in a year-to-date window, the performance on emerging market bonds are still well ahead of developed markets. However, the monthly rate of appreciation on emerging market bonds does indeed appear to be slowing.



**HARD ASSETS** suffered in May from a deep sell-off in energy linked assets. Energy assets experienced losses as the price of the commodity sunk once again. Still, energy assets have provided returns in the high single digits this year. Real-estate recorded minimal losses in May. Real-estate assets are a leading asset class this year in terms of relative performance. Investors have probably been brought into real-estate for their yields in this general environment where competing bond yields are falling.



**HYBRIDS** shared in losses of stocks just not at the same magnitude. Convertible debt underperformed the category average in May. Preferred stock experienced small losses. For the year, the performance between convertible debt and preferred stock is nearly neck-and-neck. What’s more, this year’s performance between the hybrid and US stock category averages are nearly indistinguishable. Since hybrids are either limited to or unable to participate in growth, should something change here?

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