



Heat Check: Investors Rethink Market Leadership

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Driven in part by concerns over the magnitude and speed of interest rate increases, investors have soured on stocks, especially in the Technology sector. Many of these names had previously been considered “can’t miss” darlings of the market; with that myth now shattered, their fall has been dramatic, possibly exacerbated by systematic selling by commodity trading advisors and risk-parity funds. As a result, some prior market leaders are now down about 20% from their highs, bringing the NASDAQ index into “correction” territory (down 10%).

After an extended run of strong corporate performance, merely meeting earnings expectations has become akin to having missed earnings targets. As a result, stocks that match earnings consensus have been significantly punished. While harsh, the market’s view may reflect a belief that profitability margins have peaked due to rising freight, raw materials, and labor costs.

Concerns over global growth are weighing on markets. Trade tensions between the U.S. and China are also providing market headwinds. While not new, there are increasing signs of protectionism taking its toll on economic growth, as exports declined 3.5% in the third-quarter. Moreover, initial hopes for a quick resolution to tensions between the U.S. and China have been dashed following a breakdown in recent talks.

Technical factors may also be at work, with many companies currently in a blackout period for stock buybacks. Regulations prevent companies from buying back shares during the month leading up to reporting quarterly results. Research from Goldman Sachs had previously estimated that 86% of stocks in the S&P 500 Index entered this restricted window starting October 5th. As share buybacks through 2Q had increased 50% year-over-year, it is possible that the current blackout period has removed one source of support for stocks.

A final explanation for the recent spike in volatility may simply be that the market was overdue for some turmoil. Earlier in 2018, the S&P 500 Index had completed a 50-session streak without a 1% swing in either direction for only the fifth time during the past five years. It was a period of calm almost long enough to make investors forget that the market had also swooned 10% in February, only to rebound strongly from those lows.



Investment Outlook

Although the factors outlined above keep us vigilant, on balance, economic prospects remain positive. As implied by the word “correction,” the conventional wisdom is that market declines of 10% can provide a healthy resetting of investors’ expectations.

The steep declines in Technology stocks also serve as a good reminder of why we look to control risk through limiting our sector exposure versus the benchmark. Interestingly, the recent rotation out of Technology doesn’t look to be valuation-driven, as investors bid up defensive sectors (namely, REITs and Utilities), rather than more reasonably priced stocks. In our view, fears of a recession are overblown. While the yield curve has flattened, it has not inverted, and though rising rates have dampened sales of homes and autos, both business and consumer confidence remain strong.

As stewards of your capital, we are careful not to get caught up in sector rotation, reversals, and other market moves that may be fleeting in nature. As always, we stick to the basics: building client portfolios from the ground up, stock-by-stock; buying stocks that we believe have attractive valuations and the potential to exceed investor expectations; and ensuring that we position accordingly through strict risk controls. This may not result in immediate outperformance, but over the long haul, we believe that this measured approach will serve our investors well.

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