

Investment Update



October 2015

A Fork in the Road

One of the great philosophers of our day, the late Yogi Berra, once said, "When you come to a fork in the road, take it." While we may chuckle at such an odd comment, Yogi's saying offers insightful wisdom. Often interpreted as a point in life where you need to make a pivotal decision, a fork in the road is also a conundrum that stock markets frequently face. After the pullback of late August, the market is now deciding which branch of the road to take: to move eventually higher, perhaps back to all-time highs; or to pullback further, retesting or even breaking beneath its most recent lows.

I have written in past *Updates* that market corrections are a normal part of any bull market cycle. Since 1971, they have occurred about every 2 1/2 years on average. The key concern with any correction is what it may be signaling, be it simply a growth scare or, perhaps, something more sinister, like a U.S., or even a global recession. While other minor corrections have taken place during this bull market, including the pullback in October 2014, or even the fiscal cliff correction in late 2012, the late August drawdown was different. Let's explore why.

A Different Kind of Pullback

Leading up to the correction, there were many characteristics present that differentiated this market downturn from those earlier in the bull market run. The market had been moving in a sideways pattern, generating modest returns while stock prices became more fully valued. As the market bided its time, the level of economic uncertainty grew, with sluggish global growth, a rising dollar and even fears of a hard landing in China negatively impacting the corporate profit outlook. Policy uncertainty at the Federal Reserve (Fed), with their decision not to raise rates on September 17, also served to increase volatility in developing markets as many participants saw the Fed's inaction as a sign of overall global economic weakness.

China's decision to devalue the yuan seemed to be the root cause of the pullback. In a preemptive action to delink from the dollar ahead of the Fed's move to raise interest rates, the event sent ripple effects through global equity markets. The potential for a currency war, where many pacific-rim neighbors may also decide to devalue their currencies in order to remain competitive, set off more instability in the region. Add the pressure of falling commodity prices and it is easy to see why many developing economies are struggling.

After this type of pullback, the U.S. equity market traditionally enters a bit of a holding pattern. But, like the Fed, the stock market is becoming very data dependent, monitoring global macro developments before deciding which direction it will head. The typical resolution is for markets to eventually push higher because this downturn caused the market to fall to levels that have historically represented good value. This is an important fact, as it affords "value" managers the opportunity to buy stocks that offer attractive appreciation potential from current prices, and thus provides strong support in the wake of market weakness.

Ushering a Change in Leadership

In our view, the recent pullback actually served to reset investors' views on risk and return, including the type of investments they will tend to favor going forward. History shows that when investors re-enter the stock market after such a correction, they tend to no longer favor the flashy,

price-momentum names that had led the market to its prior highs. Instead, investors have historically taken a more measured approach, favoring smaller capitalization and earnings-driven growth as they acclimate back to risk assets.

This resetting of risk/reward preferences historically occurs in both public and private (risky) investments after corrections like the one we have just witnessed. Private equity and venture capital investors typically begin holding potential acquisition targets to higher standards. We are now seeing this tendency play out as well, with modest declines in the relatively high multiples that previously characterized private firms, as potential buyers seek acquisition targets with strong profits and growth potential rather than those with just trendy business models. Even IPOs are signaling a change in mood as many have priced at either the low end or below their price range since Labor Day.

Opportunities in the Road

The holding pattern of the market, and the specific issues affecting China and EM, have led us to manage risk by reducing exposure to those asset classes we feel are most vulnerable to further market weakness. Specifically, in our last two Investment Strategy Committee meetings, we made the recommendation to deepen our underweight position in emerging markets equities and eliminate emerging market debt (both hedged and unhedged). We believe the value created in the recent pullback provided an opportune entry point to asset classes we expect will perform well over a 12 to 18 month horizon. Therefore, we recommended an increase in exposure to U.S. mid-cap stocks and international developed equities, where we believe the risk/reward opportunities are more attractive. Given our expectation that volatility will remain heightened, we also recommended increased exposure to diversifiers, like managed futures and long/short equity, to cushion portfolios in choppy markets and to harness potential positive absolute returns regardless of market direction.

During periods when markets are uncertain, it is important to remain vigilant and assess all new data for signs of either economic or market deterioration. Forecasts for GDP, earnings, and inflation are key indicators that we will monitor closely in conjunction with data on the health of the global consumer, jobs growth, and the price of oil. Negative readings across a combination of these metrics would encourage us to explore opportunities to further reduce risk within client portfolios.

Holding patterns historically end well, meaning that most often (but not always) markets resolve this fork in the road by heading higher. Given our outlook that we are in the sixth year of an eight-year U.S. economic expansion, we believe that markets have the economic support to move higher once uncertainty has had a chance to play itself to a conclusion.



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