Investment Update

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Separating Signal from Noise

It's a bit early for Halloween, but the equity markets have been scary over the past few weeks and months. Fear is problematic for investors, particularly as it often leads our focus astray. During recent interviews with CNBC and the Wall Street Journal, I was asked about two macro-driven events affecting equity markets: the impact of the Greek debt crisis on the Eurozone's recovery and implications of China's stock market rout for global growth. Neither news source asked my thoughts about the market's ability to reach new highs amid this turbulence, nor did they ask about second quarter earnings expectations—both were overshadowed by prevailing headline news.

When market media focuses on macro events, such as geopolitical risks or growth scares, rather than underlying company fundamentals, volatility is usually the price paid by investors. Growth scares, in particular, are characteristic of late-cycle bull markets if for no other reason than human nature. Investors seem to have internal clocks that tick louder as bull markets age, encouraging more and more nervousness. I mentioned on CNBC that while we are long overdue for a stock market correction, many pullbacks present a buying opportunity. Therefore it is critical to be able to identify whether a market retrenchment is a product of growth fears alone or if it is the beginning of an actual recession.

A Scary Pullback

Fear of slowing global growth came from multiple corners of the world during the latest equity market pullback. After climbing for the past year, the Chinese stock market (as measured by the Shanghai Composite) declined by over 28% in less than a month. Chinese government actions to prop up the market did little to provide support. Weakness in the prices of oil and copper further exacerbated signs of a slowing Chinese economy. Meanwhile, Greece had defaulted on a loan and rejected a referendum proposed by international creditors, making the possibility of a Greek exit from the Eurozone ('Grexit') more likely. Although Greece ultimately approved revised bailout terms and is now in the midst of negotiating its third bailout package, fear rippled throughout world markets shaking investor confidence. It should be noted that this pullback of roughly 5% to 10% was very tame when compared to the first time Grexit fears transpired, back in 2011. During that earlier crisis, the stability of the European banking system was in question as markets tried to determine which institutions held Greek bonds. This uncertainty created a cascade of sales of risk assets globally—even the U.S. equity markets reacted, falling nearly 20%. Now, risk of contagion is significantly reduced as Greek debt is held primarily by Euro-area Governments, the International Monetary Fund and the European Central Bank (ECB).

A Study of Market Declines

Pullbacks are common and more widespread than most investors would believe. Ned Davis, an economic and market research firm, studied the frequency of pullbacks during secular bull markets. Using data going back to 1926, Ned Davis calculated that the average secular bull market suffers a 5% correction every 84 days, a 10% correction every 331 days, and a 20% correction every 1,105 days. The current secular bull market has been unusual with fewer pullbacks than the historical average. As of this publication, it's been more than 160 days since a 5% pullback, more than 920 days since the last 10% pullback, and more than 1,570 days since the last 20% correction.

Taking Advantage of Market Weakness (and Strength)

In light of the fact that pullbacks are so prevalent and can happen for many reasons, the Investment Strategy Committee, which sets overall asset allocation policy, spends more time discussing their causes and ramifications and establishing an action plan instead of trying to play the fool's game of predicting when these pullbacks happen. After much discussion, our assessment of the most recent pullback was that it was driven by a temporary growth scare and would not be accompanied by a recession in the U.S. economy. Thus, we looked to take advantage of the market's weakness.

Given our belief that we are in a sub-cycle slowdown within a broader, long and gradual recovery and that U.S. equity markets are still fairly valued, we shifted our equity mix in search of more compelling risk/return trade-offs. We recommended a shift from U.S. equities—an asset class we have favored for the past few years—to international developed equities, both in small and large capitalizations. For the remainder of 2015 and even into 2016, we expect that U.S. equities will post more modest returns as compared to the last few years and that international developed equities will offer higher potential returns given the infancy of their recovery cycle. We also anticipate economic growth in the Eurozone to be stronger than most expect, as the efforts of the ECB's quantitative easing program continue to have a positive impact on business and consumer spending.

In spite of the increased allocation to international equities, which takes us to a slight overweight in the asset class, we remain underweight in emerging markets. We continue to have concerns about China's near-term growth and point to commodity prices as fresh evidence of this opinion. Brazil is also a source of concern as it wrestles with higher inflation and higher interest rates. Until we have more confidence in these larger emerging market countries, you can expect us to maintain our conservative posture towards this asset class.

Diversifiers, or lower-correlated investments, continue to be an important component in investment portfolios as they help to buffer volatility that persists during late-cycle bull markets. These diversifiers may include managed futures, long/short equity, and absolute return strategies and should act as shock absorbers that smooth the ride.

While pullbacks are always scary, we must learn to keep them in context. With rigor and diligence, we aim to separate noise from signal. We are not frightened by the current market conditions and see no cause for alarm as we believe the global economy remains in a slow and steady recovery.

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