MarketUpdate

More tricks than treats for markets in October

October lived up to its scary reputation for the markets. All three major U.S. indices were down. The Nasdaq Composite lost 9.16 percent, the S&P 500 dropped 6.84 percent, and the Dow Jones Industrial Average lost 4.98 percent.

Slowing growth and a change in sentiment with regard to large technology companies drove the stock sell-off. The big tech names have been a major driver of returns. As such, a pullback here had a disproportionate impact on the broader markets. All three indices finished the month below their 200-day moving averages. But a rally at month-end cut losses and moved them back toward the trend line.

Given this partial recovery, there is reason to believe that the sell-off may have been overdone. According to FactSet (as of October 26, 2018), with 48 percent of S&P 500 companies reporting, the blended average earnings growth rate was 22.5 percent. This result is an improvement from the beginning of the month, when analysts projected earnings growth of 19.3 percent.

International markets also experienced volatility. The MCSI EAFE Index fell 7.96 percent, and the MSCI Emerging Markets Index declined by 8.70 percent. Both indices remained below their 200-day moving averages. Political concerns in Europe and a strengthening dollar contributed to the losses.

Even fixed income markets fell in October. The Bloomberg Barclays U.S. Aggregate Bond Index dropped by 0.79 percent, driven by rising interest rates. The 10-year Treasury yield ended September at 3.05 percent. It reached a high of 3.23 percent midmonth, before finishing October at 3.15 percent. This increase was driven by rising inflation concerns.

High-yield fixed income also had a rough start to the quarter. The Bloomberg Barclays U.S. Corporate High Yield Index fell 1.60 percent for the month. The high cost of capital and a risk-off stance by investors caused turbulence here.

Slowing economic growth

October's data painted a picture of slower growth throughout the economy. Third-quarter gross domestic product growth came in at 3.5 percent (annualized), down from 4.2 percent in the second quarter. This pullback is disappointing but still represents a healthy level of growth.

Retail sales disappointed in September, with a gain of 0.1 percent. Nonetheless, spending growth remains at levels that will support continued economic growth for the time being.

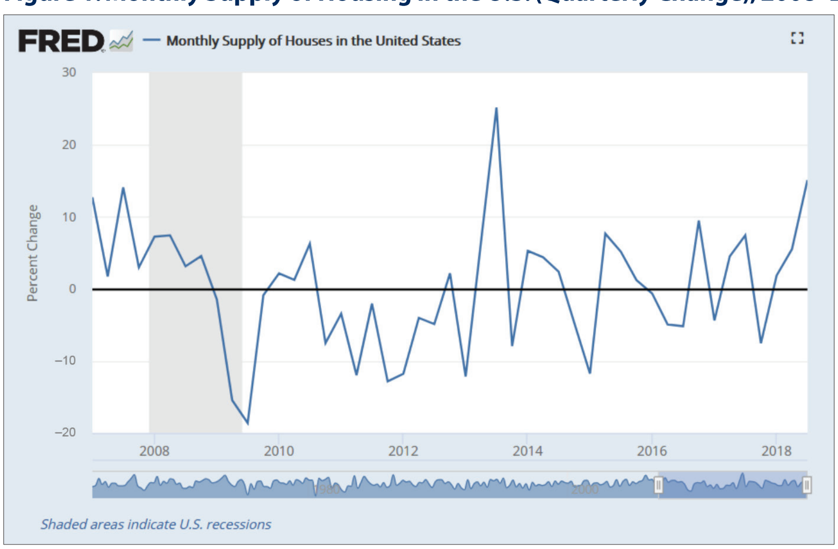
Slowing wage income growth likely drove slower spending growth. In September, only 134,000 new jobs were added. Wage growth declined to 2.8 percent (annualized). The news turned around for October, however, as employers added 250,000 jobs, and annual wage income growth rebounded to 3.1 percent. The hurricanes may have distorted the results for both months, but there is a real prospect for job growth to continue at a strong pace through the rest of 2018. There may be constraints, though, given the low unemployment rate of 3.7 percent.

Housing sales disappoint

New and existing home sales fell in September, as higher mortgage rates discouraged potential buyers. Slower demand growth also resulted in relatively large growth in available housing supply. Supply grew modestly in the first half of the year but surged more than 15 percent in the third quarter (see Figure 1).

There may be a lag between increased supply and sales growth. The recent hurricanes have also likely had an effect. Home builders remain confident in the market, so things may pick up.

Figure 1. Monthly Supply of Housing in the U.S. (Quarterly Change), 2008–2018



Source: U.S. Bureau of the Census

Political risks take center stage

Here in the U.S., the upcoming midterm elections have increased public uncertainty. But from an investment perspective, markets perform well following midterms. As such, tailwinds may resume after the midterms are over.

From an international perspective, concerns surrounding a global slowdown spooked the markets. Brexit, as well as the struggle between the Italian government and the European Union, has increased economic fears in Europe. Further, German Chancellor Angela Merkel announced she will be stepping down as head of her party. German leadership has been a major source of stability, so this will be a closely followed transition.

The ongoing trade disputes between the U.S. and China continue to rattle markets. With more tariffs pending, and companies trying to deal with the effect, this remains a risk.

Short-term risks remain, but fundamentals are strong

Concerns over a slowing global economy, elections, trade, and rising interest rates could affect the markets. But we have seen strong corporate earnings growth and solid economic data. Plus, economic growth has remained steady, even through the slowdown. Given these healthy fundamentals, we are well positioned to weather further volatility.

Plus, uncertainty will likely subside. The midterms will pass, and Europe will likely find a deal again. Even a trade agreement remains possible, which would substantially calm markets.

When you look at the big picture, things look good. Even if there is more volatility ahead, a well-diversified portfolio matched with an investor's time horizon offers the best path to reaching financial goals.

All information according to Bloomberg, unless stated otherwise.

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