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Three Concerns Weighing on the Markets

Investment Strategy Team

Key takeaways

- *The sell-off that started in October has resumed recently after a brief respite.*
- *The economy still appears solid, and we believe this is not the end of the economic cycle or the bull market.*

What it may mean for investors

- *We believe investors should continue to fight the urge to overreact to negative headlines and instead focus on implementing their investment plans.*

A variety of factors are impacting the markets, and this report considers three main concerns weighing on the markets today:

Trade War

Ambiguity surrounding a potential halt to further tariff escalation between the U.S. and China has contributed to a fresh bout of market volatility. While the outcome of last week's G20 meeting was embraced as productive by both China and the U.S., many questions remain unanswered. Late on Saturday, the U.S. announced postponement of a January 1 tariff increase, a 90-day negotiation window and potentially higher Chinese imports of U.S. agricultural products as a result of those talks. In the days since, few details have emerged, and markets are concerned that the news out of the G20 was relatively superficial given the lack of meaningful progress between China and the U.S on core issues.

Brexit

Prime Minister Theresa May's attempt at executing a "soft Brexit" faced another hurdle on Tuesday as members of parliament voted to hold the government in breach of parliamentary rules. The vote demonstrated the Prime Minister's diminished political support—particularly from key ally the Democratic Unionist Party, which voted in favor of holding May's government in contempt of parliament. This increases the likelihood that next week's vote on the Brexit bill could fail, potentially leading to a second parliament vote, a no-confidence vote for May, and potential snap elections or a new Brexit referendum in the New Year. Under such a scenario, the U.K. could find itself stumbling out of the EU on March 29 without a deal—a development that would have immediate negative consequences for the U.K., EU and the markets.

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Yield curve inversion

The belly of the yield curve has inverted with two-year Treasury rates now higher than five-year Treasury rates. We do not think investors should be overly concerned with an inversion in the belly of the curve, but the increased pace of curve flattening is worth keeping a close eye on. Should two-year Treasury yields move above the 10-year Treasury yield, we would expect increased media attention that may further weigh on markets. Our level of concern would increase if we saw the one-year Treasury versus the 10-year Treasury curve invert. Ask your investment professional for a copy of our report *Power in the Yield Curve* for details regarding our yield curve inversion research.

We still see a solid U.S. economic outlook, but concerns about a global growth slowdown are pulling down strong U.S. growth and investor sentiment. Still, the bottom line, in our opinion, is that an economic recession is not imminent—even as many areas of financial markets are pricing like we are heading for one.

When market sentiment turns so negative, stock price levels make a difference in the near-term outlook. We would become more concerned if the S&P 500 Index breaks below price levels that have been supports during selling episodes earlier this year. Those important support levels include the October 2018 lows (2640-2655) and the lows from the first quarter of 2018 (2581-2605).

What should investors do now?

Keep perspective: We believe investors should continue to fight the urge to overreact to negative headlines, and instead, focus on implementing their investment plans, which should include asset allocation, diversification, and rebalancing as core components.

Look for opportunities in equities: As we wrote in October, market action this year probably marks the end of the unprecedented period of low volatility and above-average returns across equities, fixed income, and currencies.[1] Yet, the economy still appears solid, and we believe that this is not the end of the cycle or the bull market. We view now as a time to be ready to increase equity exposure in favorable areas, such as U.S. large-cap, U.S. mid-cap, and emerging market equities, and favor deploying cash now—or even allocating incrementally over the coming days and weeks. In our opinion, current conditions have the potential to create some of the best entry points into equity markets since the November 2016 elections.

[1] Please see WFII *Institute Alert,* "Opportunity Amid the End of Easy," October 15, 2018.

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