What's Behind This Week's Big Sell-Off?

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From Invesco: On Wednesday, US stocks fell dramatically, with the Dow Jones Industrial Average falling more than 800 points. The rout was led by technology stocks, with the NASDAQ Composite Index down 316 points, but all sectors experienced losses.[1]

This was the worst one-day sell-off for US stocks since February. For much of the day, bonds sold off as well but, by the end of the day, investors fled to the perceived safety of US Treasuries, sending yields lower.

What drove the sell-off?

Stocks began losing ground last week as the yield on the 10-year US Treasury spiked, helped by comments from US Federal Reserve (Fed) Chair Jay Powell, who suggested that the Fed could raise rates significantly before finishing its rate hike cycle. Also placing downward pressure on Treasury prices has been balance sheet normalization as well as higher debt issuance as a result of the US government running a larger deficit. As we have seen before, any significant increase in the 10-year yield typically results in a re-rating of stocks. Less than a month ago, the yield on the 10-year was 2.991% but since then it has risen rapidly, rising above 3.2% in the past week.[1] Given that the tech sector has posted such strong returns in the past several years, it should not come as a surprise that it experienced a more severe re-rating than other sectors.

However, I also believe there is another reason for the sell-off: the growing trade wars. At times in the past year, protectionist threats and actions have sent stocks modestly downward, but investors have been all too willing to believe the threat has passed at the first sign of an abatement in trade drama. For example, after trade worries put downward pressure on stocks earlier this year, Chinese President Xi Jinping's conciliatory speech at the Boao Forum in March was all investors needed to hear to send stocks upward. Realistically, this asymmetric reaction to trade developments — i.e., overreaction to positive trade news and underreaction to negative trade news — was not sustainable. In addition, negative consequences from the ongoing US-China trade conflict had not yet appeared in the data, especially in the US where the economy is accelerating, giving markets another reason to discount the threat. But that has started to change. This week, the International Monetary Fund (IMF) downwardly revised its estimates for global growth, as well as growth for China and the US, as a result of the escalation in trade tensions:

- The IMF projects that long-term gross domestic product (GDP) for the US and China will each decline 0.3% as a result of all the tariffs implemented as of September 2018.[2]

- It expects long-term US GDP to decline 0.5% and long-term China GDP to decline 0.55% if the US imposes its threatened 25% tariff on an additional $267 billion in Chinese goods, and China retaliates.[2]
- In addition, it expects long-term US GDP to decline 0.9% and long-term China GDP to decline 0.6% if the US imposes its threatened 25% tariffs on cars and parts, and then trading partners retaliate.[2]
- The IMF of course expects this to have a negative impact worldwide, with long-term global GDP projected to decline 0.4% if all tariffs discussed above are implemented.[2]
- The IMF expects the impact of the current trade conflict to be felt in 2019: its estimate for US GDP growth was downwardly revised to 2.5% from 2.7%, while China GDP growth was downwardly revised from 6.4% to 6.2%.[2]

In addition, companies are beginning to report that tariffs are impacting their businesses. On Wednesday, US-based industrial supply company Fastenal reporting earnings and discussed the headwinds being created by the trade conflict, in particular sharing that the most recent tariffs are "directly impacting the North American supply chain for our customers." This disruption of global supply chains has been a major concern for economists and strategists. As the Cato Institute explained in a commentary earlier this year[3], "Whereas in the 20th century, most of a company's production and assembly took place in one location, often under one roof, the factory floor has since broken through those walls and now spans borders and oceans. Taxing imports today is akin to erecting a wall through the center of that 20th century assembly line, impeding production and raising costs in similar fashion. That helps explain the preponderance of opposition among US manufacturers to Trump's trade tack. US tariffs raise their costs, and the resulting retaliation from foreign governments will reduce their export revenues, squeezing profits from both ends."

What are the potential investment implications?

There are concerns afoot that this could be the start of a market correction, and it may very well be. I have warned about the likelihood of a sell-off in the back half of the year that resembles the February sell-off — meaning a sharp but relatively swift sell-off and then the potential for a recovery.

In a survey we at Invesco conducted both before and after the February sell-off, we found that investor confidence in stocks diminished after the sell-off — in the first quarter, 80% of investors felt it was a good time to invest, but that declined to 69% in the second quarter. Moreover, before the sell-off, 65% of investors believed we were in a bull market, compared with just 37% after the sell-off in April. To me, this suggests investors may flee stocks at the first sign of trouble.

And so I believe there will be some contagion in the near term — indeed, Asian stocks are already down.[1] I expect a significant sell-off that extends internationally, although I expect the US will feel the most pain. Having said that, earnings season is likely to be strong, in my view, which would provide some support for stocks and may help them rebound relatively quickly.

What is our outlook on the situation?

I have been warning for more than a year that the two key risks to the economy and markets are normalization by the US Federal Reserve and protectionism. It seems that these forces are both at play, creating something of a “perfect storm” that is causing market disruption. Having said that, I believe that longer-term investors, especially institutional investors, who need capital appreciation potential in order to achieve investment goals should consider maintaining exposure to risk assets, but with an emphasis on downside protection. Therefore, this could create an opportunity for active management, especially in certain asset classes.

I have also been warning that these risks underscore the importance of broad diversification — that may mean diversification within equities (by region and factor) and fixed income (by sub-asset class) but also adequate exposure to alternative asset classes, which have historically exhibited lower correlations to equities. Unless an investor has a short time horizon, I believe it is important to consider a broadly diversified investment portfolio that includes risk assets. In addition, tactical investors can take advantage of buying opportunities created by the sell-off.

What are we watching out for?

We will want to follow the trade situation closely. If it deteriorates significantly, a reduced exposure to risk assets may be warranted.

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1 Source: Bloomberg, L.P., as of Oct. 10, 2018

2 Source: International Monetary Fund

3 Source: Cato Institute, “Trump’s Trade Wars Are Incoherent, Angry and Misguided,” June 22, 2018

Important information

Diversification does not guarantee a profit or eliminate the risk of loss.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Fixed income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer’s credit rating.

The Dow Jones Industrial Average is a price-weighted index of the 30 largest, most widely held stocks traded on the New York Stock Exchange.

The NASDAQ Composite Index is the market capitalization-weighted index of approximately 3,000 common equities listed on the Nasdaq stock exchange.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

Contagion is the likelihood that significant economic changes in one country will spread to other countries.

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