MARKET NOTES

Week of August 21, 2017

A Rocky Ride for Investors as Volatility Rears its Head

Equity markets experienced significant volatility last week. Global stocks rebounded early, as geopolitical tensions between the U.S. and North Korea eased. But stocks fell sharply later in the week—the S&P 500 suffered its biggest one-day percentage drop in three months on Thursday, for example. The losses were driven by (among other things) terrorist attacks in Spain, fears about the impact on businesses if the Trump administration is unable to pass its legislative agenda, and disappointing earnings from tech giant Cisco that pushed down technology stock prices in the U.S.

Ultimately, U.S. stocks ended the week down slightly. Interest rate sensitive sectors Utilities and Real Estate performed the best last week as interest rates fell. Energy-related companies were the poorest performers, as increased oil production sent oil prices lower. International markets outperformed the U.S. for the week, driven primarily by emerging markets, which was the best-performing foreign asset class.

In the fixed-income markets, uncertainty also created volatility. Bond yields initially rose as tensions between North Korea and the U.S. eased. But terrorist attacks in Spain and political uncertainty in Washington D.C. sparked a global flight to safety that pushed longer-duration government bond yields back down to roughly where they started the week. Additionally, comments from the Fed about low inflation caused some investors to predict the Fed would move slowly in raising interest rates going forward.

Through it all, the global economy showed signs of resilience. The U.S. saw generally positive economic data, with stronger-than-expected retail sales in July as well as initial jobless claims in early August that were lower than expected. Overseas, both Japan and Europe generated second-quarter GDP growth that topped estimates. Japan's growth was particularly strong—4.0%, versus forecasts of just 2.5%.

In contrast, the UK reported disappointing inflation numbers, while industrial production in Russia was well below expectations.

GAIN: Active Asset Allocation

Fading concerns about U.S.-North Korean tensions boosted stock prices early last week, but equities later fell and finished slightly lower than where they ended the previous week. Foreign markets, which were hardest hit in the wake of the geopolitical tension, outperformed the U.S. market.

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We continue to maintain a broadly diversified equity portfolio. The strongest-performing stocks during the first half of 2017 have become more volatile recently, with investors looking to take profits when market volatility rises. This could mean the market is bit "tired."

A similar trend exists in the fixed-income markets. Corporate credits have been and remain a significant theme in our portfolios, but we reduced our exposure last week to lock in some of the gains from this asset class. We perceive increased risk in these securities given the recent behavior of the stock market.

PROTECT: Risk Assist

Equity market volatility rose sharply late last week, as stock market gains early in the week were erased by numerous developments that spooked investors—including the shuttering of President Trump's corporate advisory councils and rumors that top White House economic advisor Gary Cohn may resign, both of which sparked new fears about the Trump administration's ability to pass its economic agenda. In addition, a terror attack in Spain caused volatility to jump.

The Risk Assist portfolios remained fully invested through this bout of volatility. Of course, we continue to monitor the portfolios daily and will make adjustments if necessary.

SPEND: Real Spend

A rebound in equities early last week gave way to significant losses on Thursday, along with a spike in the CBOE Volatility Index (or VIX), as investors worried about a number of domestic and global challenges. One issue: Slower-than-expected inflation growth of just 1.4% in June was revealed to be a topic of concern among members of the Federal Reserve Board. That said, many Fed members—including Chairwoman Janet Yellen—believe low inflation may be short lived due to temporary price drops in specific cyclical components of the economy.

It is important to remember that the Real Spend portfolios allocations are focused on long-term return expectations for equities and fixed-income. Therefore, the success of the Real Spend strategy is not determined solely by short-term market fluctuations such as those we saw last week.

In addition, volatility in the Real Spend allocations is to be expected, as it is reflective of the asset class exposures necessary to generate the long-term returns important for sustaining investors' desired inflation-adjusted spend rate over long retirement horizons.

Despite the recent volatility, the spending reserves in all Real Spend models remain at their maximum capacity—holding three years' worth of the desired spend rate for each model.