ASSESSING RECENT MARKET DECLINES

Key Factors & Historical Context

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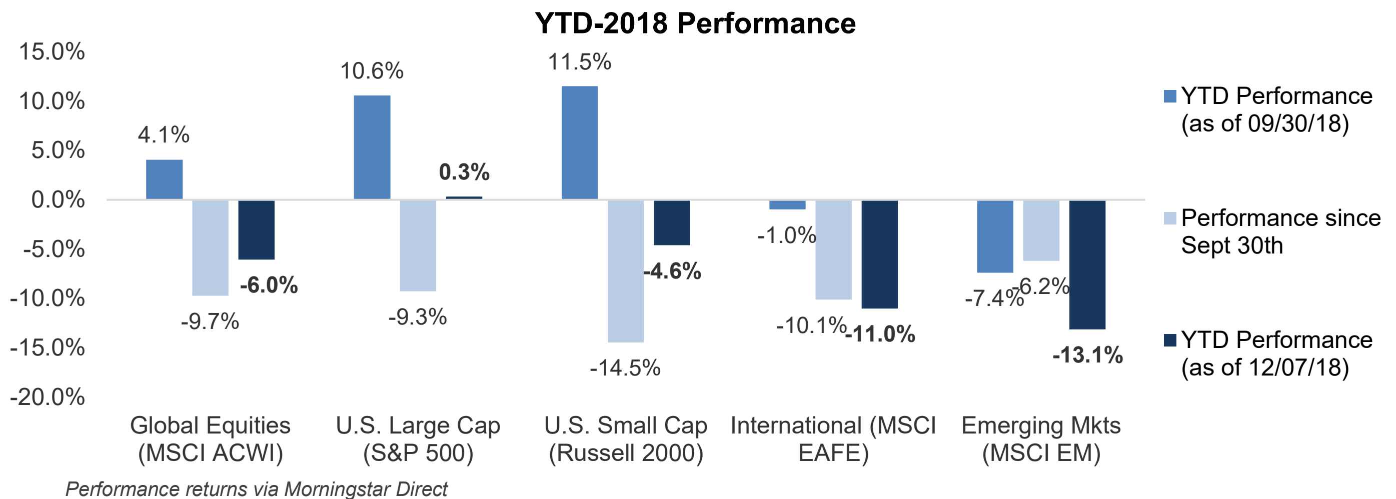
On December 4, equity markets fell sharply as investor optimism faded over the recently struck 90-day tariff truce between the U.S. and China. The S&P 500 Index and Russell 2000 Index slumped -3.2 percent and -4.4 percent for the day, respectively. Tuesday's activity marked a sharp reversal from just a day earlier, as equities had gained more than 1 percent on Monday over hopes that the U.S. and China might find an amicable solution to long-running trade disputes. Over the past year, investors have become increasingly concerned that the U.S.-China trade impasse could escalate into a broader trade war, which could have negative implications for global growth and notably at a time when global economic data has been weakening.



Performance returns via Morningstar Direct

Adding further to Tuesday's declines, portions of the Treasury yield curve recently inverted, with two-year and three-year yields slightly exceeding the five-year yield for the first time since 2007, stoking investor concerns of a looming economic slowdown.

Treasury Yields (12/04/2018)								
3 mo	**6 mo**	**1 yr**	**2 yr**	**3 yr**	**5 yr**	**7 yr**	**10 yr**	**30 yr**
2.42	2.58	2.71	2.80	2.81	2.79	2.84	2.91	3.16

Source: Treasury.gov

Why does an inverted yield curve matter? For a healthy and growing economy, longer-term rates are higher than shorter-term rates as investors demand greater compensation for the risk of inflation and interest rate increases. When

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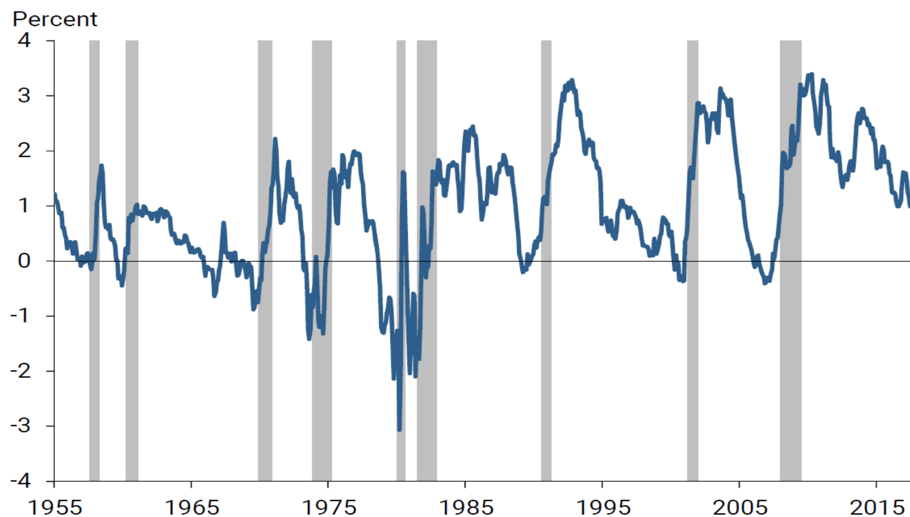
the yield curve inverts, it generally signals that investors are concerned that economic growth will slow down from current levels.

Historically, an inverted yield curve has been a strong predictor of future recessions (as was detailed in our recent whitepaper *Keep Your Eyes on the Yield Curve*), explaining why investors place such an emphasis on the shape of the yield curve. Research by the Federal Reserve Bank of San Francisco has shown that an inverted yield curve (in this case, the difference between one-year and ten-year Treasury yields) "has correctly signaled all nine recessions since 1955 and had only one false positive, in the mid-1960s, when an inversion was followed by an economic slowdown but not an official recession."



Source: Federal Reserve Bank of San Francisco

Similar research by the Cleveland Fed has shown that an inversion between three-month and ten-year Treasury yields has preceded each of the past seven recessions, though that spread has yet to invert (currently at 0.50 percent). Using the yield curve as a recession predictor, the Cleveland Fed currently estimates the odds of a recession within the next year at only 20 percent. For additional perspective, a recent Reuters poll of economists pegged the probability of a U.S. recession within the next two years at approximately 35 percent with U.S. trade policy cited as one of the economy's biggest downside risks.

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Many investors assume that an inverted yield curve implies an imminent recession though that is not necessarily the case. The San Francisco Fed's research notes that the delay between an inverted yield curve and a subsequent recession has ranged between six and 24 months. It is also interesting to note that a yield curve inversion does not imply negative market returns immediately thereafter. In fact, when looking at data from the past five recessions, the S&P 500 Index still produced positive returns following an inversion.

AN INVERTED YIELD CURVE ISN'T TROUBLE IMMEDIATELY

2–10 Year Yield Curve Inverts	S&P 500 Peak	Months From Inversion Until S&P 500 Peak	S&P 500 Price Return From Inversion to Peak
08/18/78	09/12/78	0.8	2.2%
09/12/80	11/28/80	2.6	11.9%
12/13/88	07/16/90	19.3	33.2%
05/26/98	03/24/00	22.3	39.6%
01/31/06	10/09/07	20.5	22.3%
	Median	19.3	22.3%
	Average	13.1	21.8%

Source: LPL Research, FactSet, 07/12/18

In addition to mounting concerns over global growth and interest rates, recent equity market declines have also been compounded by a notable selloff within the technology sector, which had meaningfully contributed to U.S. equity

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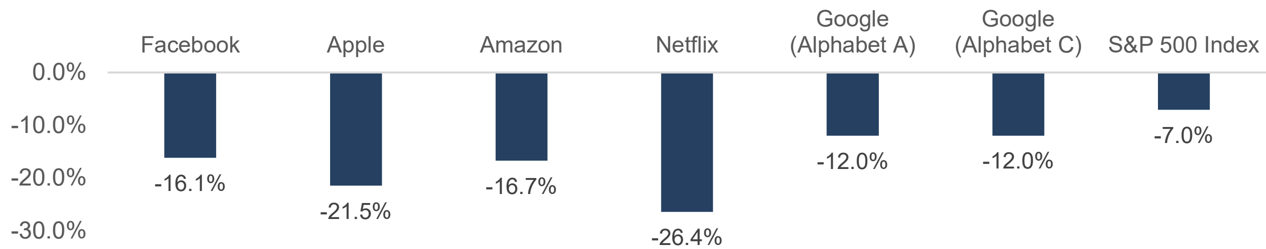
market returns over the past several years. Big technology companies (such as the FAANGs) have come under increasing pressure in recent weeks as investors have grappled with mixed earnings and less optimistic outlooks, calling into question the valuations of previous high flying stocks. Some investors fear that the S&P 500 Index may be harder pressed to produce significant gains going forward should the technology sector no longer be a top performer.

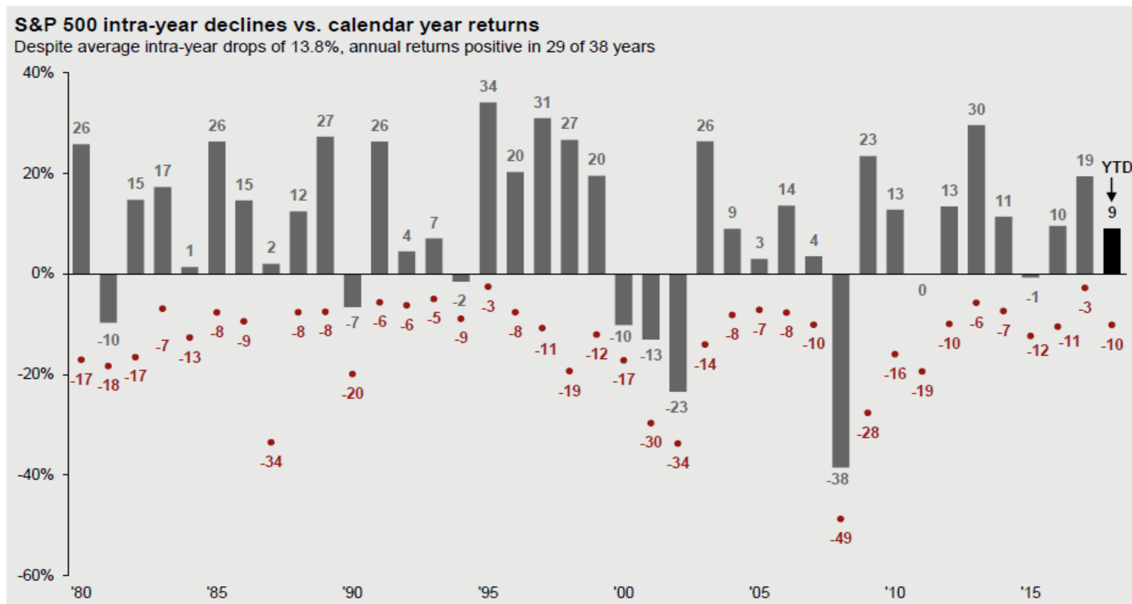
FAANGs Falter

Performance from 09/30/18 - 12/04/18



Source: Morninginstar.com

While the news headlines may highlight the severity of the recent pullback, the reality is that recent market declines are well within the norm of longer-term market cycles. Since January 1980, the S&P 500 Index (U.S. Large Cap stocks) has experienced an average intra-year decline of approximately 14 percent. Over that period, the index had an intra-year decline of more than 10 percent in nearly half of the years observed and had an intra-year decline of more than 15 percent roughly a third of the time. Nevertheless, the S&P 500 Index still produced positive returns in 29 of 38 calendar years despite those notable declines.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

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The chart above serves as a practical reminder that investors who sold following a sharp decline would have likely sacrificed significant long-term gains, having missed out on the subsequent market recovery.

In closing, we recognize that market pullbacks such as we have recently experienced can be trying times for investors. During periods of heightened market volatility, investors may feel the urge to make sweeping portfolio changes, though such moves are often ill-timed and can significantly impair the effectiveness of a prudently designed investment plan. Investors should periodically revisit long-term objectives and time horizon to evaluate whether portfolios are appropriately positioned with risk tolerance.

As was noted in our *October Market Update*, we do not find compelling reasons at this time that would justify overriding our asset allocation methodology despite elevated uncertainty. DiMeo Schneider & Associates, L.L.C. continues to believe that investors should be patient and adhere to a well-constructed, diversified investment portfolio anchored to long-term goals and time horizon.

For more information, please contact any of the professionals at DiMeo Schneider & Associates, L.L.C.

About the Author:

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Nick provides investment consulting services to nonprofit organizations, corporate executives, family trusts and other high net worth investors. He services clients by providing advice and expertise on asset allocation, portfolio design, investment policy statements, manager search process and overall investment management. Nick is also a member of the firm's Core Investment Strategy Group. Prior to joining the firm in 2007, Nick was a Senior Financial Planner with The Ayco Company where he provided comprehensive advice to affluent clientele. Nick earned a BA in Finance and Economics from the University of Illinois at Urbana-Champaign. He obtained the designation of Certified Financial Planner (CFP®) from the College of Financial Planning and is a CFA® charterholder and member of the CFA Society of Chicago. Nick enjoys long distance running (having completed three marathons and multiple half-marathons) and spending time with his family.

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