Northwestern Mutual®

# What’s Behind the Volatility?

**January 2019**

On Dec. 24, the Dow Jones Industrial Index dropped 653 points to notch its worst Christmas Eve trading session ever. Just two days later, the Dow soared 1,086 points – its biggest daily point gain ever.

It’s just a taste of the volatility that came to define the stock market in 2018, and as we flip the calendar into 2019 here is what we believe investors should expect.

## WHAT’S BEHIND THE VOLATILITY?

First off, what’s behind the market’s manic behavior?

Heightened geopolitical fears, such as the U.S.- China trade war, Brexit and the partial U.S. government shutdown have cooled market sentiment over the past few months. While we believe these are all temporary disruptions, we do remain concerned that the rise of populism and protectionism around the globe may prove stickier.

These issues have been accentuated by fears that central banks around the globe will make policy errors as they steadily push toward “normal” monetary policies. The U.S. Federal Reserve has raised interest rates for five straight quarters, which sparked concern that it is tightening the economy into a recession. Ironically, this recent bout of market volatility began in early October with a comment from the Fed Chairman Jerome Powell that, we believe, was meant to be positive, but ended up spooking the market instead.

These two fears, geopolitical tensions and monetary policy, are driving volatility. That increased volatility, in turn, is slowly seeping into economic data and creating a negative feedback loop. Underlying it all is the notion that this economic cycle must come to an end simply because it has lasted so long. This has left investors ultra-sensitive to any signs that this expansion is drawing to a close and causing them to panic out of equities.

## STILL STRONG

We don’t see the worst-case scenario (recession) the market seems to be pricing in coming to fruition in 2019. Still, that doesn’t mean the year will be less volatile for investors; as such, it’ll be very important to tune out the noise and stick to a strategic financial plan.

While a few economic indicators have wobbled, the preponderance of evidence continues to point to positive economic growth – albeit at a slower pace nearer to the potential long-term growth rate of the U.S. economy. While global economic growth has been relatively weak, the world’s second biggest economy, China, has recently moved from intentionally slowing their economy to pull back excesses to now stimulating it. This should help stabilize global growth.

Most importantly, the foundation of the U.S. economy remains solid. Recessions in the U.S. have historically occurred when the U.S. consumer and/or the U.S. banking system destabilize. The two recessions that earned the adjective Great (Great Depression of the late 1920’s and The Great Recession of 2007-2009) occurred when both the consumer and banking system were weak. Today, both the banks and the consumer are strong.

The consumer: For much of the post Great Recession years the consumer has eschewed debt and increased their savings. As a result, consumer balance sheets are strong with debt-to-asset ratios at levels not seen since 1985. And from an income statement perspective, companies are hiring, consumers are now getting wage increases and their debt expense remains low.

The banks: Bank balance sheets are in a strong position after years of stress tests and raising capital to strengthen their ability to weather economic storms. Bank lending surveys continue to point to their willingness to lend and provide liquidity to the U.S. economy.

Rising corporate debt and shadow banking are increasingly areas of concern, but we share the sentiment of the U.S. Federal Reserve: These issues do not yet flash a red warning signal.

## MONETARY AND FISCAL OUTLOOK

We don't believe the Federal Reserve's rate hike strategy has been the main driver of recent market volatility. However, the Fed's haphazard communication of the plan has markets confused. With inflation moderating and the economy slowing, we expect the Federal Reserve will take – and clearly communicate – a very measured approach to any future rate hikes. We don't believe their goal is to tip the U.S. and global economy into recession but rather to create the conditions for further economic growth.

We believe that policymakers will sufficiently "solve" geopolitical issues. We admit this is the most difficult aspect to handicap, but we believe that rationality eventually wins. Unfortunately, compromise often occurs only after the market forces policymakers' hands.

In every negotiation, each side comes to the table with their BATNA (Best Alternative to a Negotiated Agreement), or the minimum they want to gain in the event a fully negotiated agreement proves elusive. Chinese policymakers need economic stability to remain in power. This U.S. administration measures its success based upon economic growth and stock market growth. The recent economic and market soft patch increases the odds a deal gets done. We believe that both administrations will find a sufficient path forward in the coming months that will appease markets.

## OUTLOOK FOR STOCKS

Equity markets are cheap relative to bonds. Given our forecast of continued economic growth, we believe that equity markets in 2019 will rise. Recessions cause lasting bear markets and we believe that recessions occur after the following conditions are met: The U.S. economy runs out of slack, which leads to rising inflation and causes central banks to raise rates aggressively. We don't believe that these conditions have been met and are unlikely to be met in 2019. Therefore, we believe the economy will eventually tug the markets higher.

However, as we noted throughout 2018: We believe that volatility will remain high as we lurch toward the end of the economic cycle.

## WHAT SHOULD YOU DO?

The past few months have reinforced the importance of working with an advisor to develop an overall financial plan. Your plan sets the long-term asset allocation that allows you to reach your short, intermediate and long-term goals. This is the backbone of successful investing. Through Great Depressions, Great Recessions, wars and other risks – the tenets of long-term investing have held up. We expect the coming years to prove no different. Make sure that each part of your portfolio allocation has a purpose toward accomplishing a goal. Cash, bonds and life insurance cash value

are for nearer term needs while stocks and other riskier assets will help you accomplish your intermediate to long-term goals.

And remember: Stocks earn excess returns historically because they are risky. This means they aren't for everyone. Those who can hold them through good times and bad earn the extra return they provide; often at the expense of those who sell them and forgo future gains. No one should be panicking and selling stocks during periods of market distress. While it is never comfortable seeing red in your account, panic isn't an investment strategy, having the discipline to stick to your long-term asset allocation and financial plan is the best move you can make.

Happy New Year,

Brent Schutte

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*The opinions expressed are those of Northwestern Mutual as of the date stated and are subject to change. Please remember that all investments carry some level of risk, including the potential loss of principal invested.*