Market Perspectives

U.S. equities continued their strong performance, ending the second quarter of 2019 with the S&P 500 index up 4.3%. The trend of growth-oriented stocks outperforming value-oriented stocks continued as well across all company sizes. On the fixed income side, interest rates declined across the board in the U.S. and with investors continuing to look for safe havens, higher quality corporate and taxable municipal bonds[1] both posted returns of 4.5%.

Interestingly, while both stocks and bonds went up handily for the quarter, bonds actually outperformed the S&P 500 by 0.2%. Bonds beating stocks? What do we make of this unusual situation?

What to make of these markets?
Most financial news recently has been about the risks of late cycle investing, the disruptions caused by trade wars, and the threats of global political conflicts. In spite of these pressures, the U.S. economy has continued to hum along seemingly unconcerned about these domestic and global uncertainties. Yet, there are some signs that investors are beginning to pay attention and may be worried about a possible recession. Investors seem to be watching closely and markets seem to be responding most dramatically to what the Fed might or might not do.

For example, volatility which had all but disappeared in the last decade came back full throttle when, in December, the Fed raised interest rates for the fourth time in 2018. In past cycles, Fed tightening too far in the late stages has led to a recession. Investors, concerned that the Fed had once again overreached in raising rates, reacted. The stock market's upward trend came to a screeching halt, plummeting 20% from its high-water mark reached in the 3rd quarter, and handing the S&P 500 its first down year since 2008. The Fed then abruptly pivoted its position and indicated that they may instead cut rates. This led to a dramatic turnaround for stocks which forged a remarkable 26.4% rebound into the 2nd quarter of 2019.

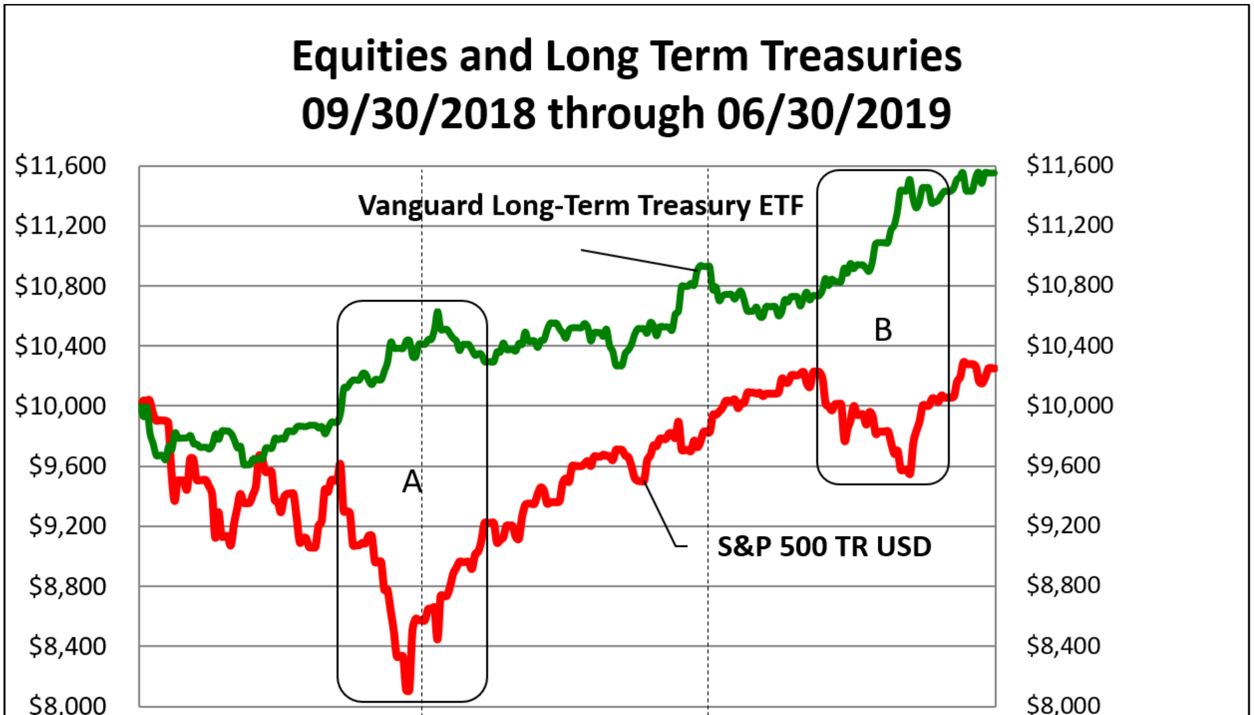
This return of volatility seems to have spooked investors who poured over $225 billion into money market funds and $235 billion into bond funds between December 2018 and June 2019. During the same period, $45 billion flowed out of equity funds, primarily from international equities and growth-oriented strategies.

Volatility Matters and Correlation Counts – Still True
The chart below demonstrates the dichotomy between stock and bond returns for the last three quarters as evidenced by the growth of $10,000 for the S&P 500 Index and the Vanguard US Long Term Treasury ETF (VGLT). The quarterly returns for the indices are shown in the table below the graph.

Following the green line, you'll see that as safety-seeking investors piled money into U.S. Treasuries, yields declined and prices rose -- up 4.5%, 4.6% and 5.7% -- in each of the successive quarters. Comparatively, stocks marked in red below, were on a Fed-propelled roller coaster ride, dropping

[1] Bloomberg Barclays U.S. Corporate Bond Index and Taxable Municipal Bond Index.

precariously from their peak in 2018 and then ricocheting back into record territory this spring. The quarterly returns for the S&P 500 during this period were -13.5%, +13.6% and +4.3%.



Total Return (%)	Q4 2018	Q1 2019	Q2 2019	Average Return	Cumulative Return
VGLT*	4.5	4.6	5.7	4.9	15.5
S&P 500	-13.5	13.6	4.3	1.5	2.5

Source: Morningstar, Waypoint Advisors. *Vanguard Long Term Treasury ETF

So, while it may seem that stocks have been rocking this year because of the high degree of volatility, the average quarterly return of the S&P 500 for the last 3 quarters was only 1.5% as compared to the average of the VGLT ETF at 4.9%. However, the real difference shows up in the compounded return which determines how much money you end up with at the end. When examining the compounded rate of return, the dramatic difference between 15.5% for long-term treasuries (VGLT) versus 2.5% for the S&P 500 becomes clear. The 13% outperformance by long-term treasuries (VGLT) equates to $1,300 more than the S&P 500 at the end of the period.

While in the past we have presented hypothetical illustrations of why volatility and correlation are so important to understand, we see in the illustration above an example of how these concepts actually work in real life. Areas A & B in the chart show the potential damage that downside volatility can do to a portfolio (red line) and how harnessing upside volatility (green line) can offset downside volatility. Combining negatively correlated assets in a portfolio that is periodically rebalanced can lead to better returns over the long run.

Uncertainty Continues to Abound

With the Fed potentially decreasing rates in response to slowing global growth and with tariffs and other geopolitical tensions creating continued uncertainty, investors face a challenging market environment.

How much investors will heed other harbingers of market decline such as an inverted yield curve is yet to be determined. The markets are likely to continue to see-saw for the foreseeable future.

And the economy, while not yet unhinged by tariffs, Middle East tension, and domestic political strife, may succumb to recession. As all of this is occurring, return forecasts across asset classes for the next decade are significantly lower than in the past. So, in an era of low returns and heightened volatility it may be prudent to rein in risk and prepare for continued market unrest. As our chart above shows, it is not only about how much your portfolio returns, but how your portfolio holds up during market downturns. Going slow and losing less can lead to a less stressful ride and possibly even better returns in the long term.