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Markets Have Been Waiting for a Pullback

Last Friday, equity markets fell sharply, with the Dow Jones Industrial Average dropping 666 points or 2.54%. This decline represented the largest single-day percentage loss since a 3.4% fall in June, 2016. Similarly, the S&P 500 sank 2.1% on Friday, which was its fourth decline in the past five trading days, extending a 3.8% loss for the week, its largest weekly decline in two years. Even beyond these headline numbers, Friday's sell-off was clearly widespread as all 11 major sectors ended negative and over 92% of S&P 500 companies posting a loss for the week. After nearly nine straight years of market gains, last week represented a reversal.

Driving the market sell-off were mounting concerns over the jump in bond yields, as the 10-year Treasury yield rose 0.19% to 2.85% last week. This is in contrast to its historic low of 1.37% on July 5, 2016. A stronger-than-expected January payroll report that indicated a 2.9% year-over-year increase in average hourly wages, the highest 12-month growth in wages since May 2009, was the primary cause of the jump in yields. Investors were concerned that strong wage growth could prompt inflationary concerns for the Federal Reserve, which could respond with a more aggressive plan to raise interest rates. Given how mortgage rates, credit card interest rates and other borrowing costs tend to take their cue from the Fed, economic growth may be impacted.

The question for investors today is whether last week's sell-off is the beginning of a bear market or a just a pause. While we are firmly in the camp that last week was just a market pause that may linger into this week, we do believe a pickup in volatility will be the new norm. To the first point, though valuations are extended, we believe there are still positive fundamentals in the market. These include continued strong corporate earnings, tax reform benefits to both the consumer and business, the fact that inflation can be good for the economy as companies can raise prices, and a weak dollar is great for U.S exports.

To the second point, we have been calling for increased volatility for some time, as the Federal Reserve becomes less accommodative in their policies. The recent sell-off is not that unusual, but something we have not seen in a long time. Before the pullback, we had gone the longest period without a 3% sell-off (drawdown from peak) in the S&P 500 (311 trading days). The next longest streak was 241 trading days, and that dated back to 1995-1996. Taking all of this into a historical context, 3% selloffs generally happen every 32-trading days, so the most recent period without such a dip was really the anomaly.

While we return to volatility levels that are more typical, investors should remember to be diversified in their portfolios and not have too much risk in one area. Equities are at high valuations and bond yields are still at relatively low levels. There are risks in both bonds and equities, so diversifying within and amongst different asset classes is important. One way to diversify overall portfolio risk is to use alternative investments, which tend to have low correlations to these traditional asset classes. Given the inflation concerns that triggered last week's selloff, commodities are also a good diversifier as their value may rise in inflationary periods. Furthermore, gold is considered a safe haven investment that may do well when equities sell off severely.

Because markets are concerned with the sharp jump in bond yields, having lower duration exposure (interest rate sensitivity) makes sense. However, since yields have risen so fast and domestic yields trade much higher than other developed nations, we would not eliminate all duration in your portfolio. Furthermore, it is imperative to diversify the types of exposure within fixed income. However, too much high yield exposure can carry equity-type risk and defeat some of the diversification benefits from owning bonds.

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Glossary

*The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.*

*The **S&P 500** is an index of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe*