MARKET Insights

Webster Private Bank®

September 2017

Sound and Fury

The possibility of war on the Korean peninsula rattled nerves in August. Thus far, however, the impact on financial markets has been muted. The S&P 500 declined **-2.2%** from August 7th to August 18th in the wake of tough-talk volleys between the White House and the North Korean People's Army. Markets have recovered quickly from such bad news because the underlying fundamental economic situation is very positive. US economic growth was revised upward to **+3.0%** in the second quarter of 2017. Inflation remains low (CPI **+1.7%**) and employment trends (+156K payrolls in August) continue on a positive upward trajectory.

Wēi-jī: Danger + Opportunity

President Kennedy was fond of reminding his campaign audiences that the Chinese characters for the word "crisis" (危机, or wēi-jī) mean "danger" and "opportunity." Geopolitical crises have predictable patterns of rattling the stock market in ways that provide investment opportunities. A major military or terrorist crisis often disturbs markets in the initial days, but later the stock market (as measured by the Dow Jones Industrial Average) typically rebounds from the losses.

Since 1982, the stock market has declined by a few percentage points, on average **-2.4%**, in the midst of a military or terrorist crisis. Subsequent returns in the following six months and year ended up **+6.8%** and **+7.8%**, respectively. The worst outcomes, such as in 2000-2002 and 2008-2009, indicate that the crises had little impact on the overwhelming downward trend in those severe bear markets. Currently, economic conditions resemble nothing like 2000 or late 2007: GDP growth remains steady and strong; stock valuations, while elevated, are not extreme; the global banking system is less leveraged; and corporate cash flows are healthy while default rates are historically low.

MARKET REACTION TO TIMES OF CRISIS

MILITARY OR TERRORIST CRISIS	EVENT DATES	MARKET RETURN During Event	MARKET RETURN 6 Months Later	MARKET RETURN 1 Year Later
Falkland Islands War begins	Apr 1 - May 5, 1982	4.3%	20.8%	41.8%
Beirut US Marine barracks bomb	Oct 21-23, 1983	0.0%	-6.9%	-2.9%
US invades Panama	Dec 15-20, 1989	-2.7%	8.0%	-2.2%
Iraq Invades Kuwait	Aug 2-23, 1990	-13.3%	16.3%	22.4%
World Trade Center bombing	Feb 25-27, 1993	-0.3%	8.5%	14.2%
US embassies bombed in Africa	Aug 6-14, 1998	-1.8%	10.4%	32.0%
USS Cole bombing in Yemen	Oct 11-18, 2000	-4.2%	6.1%	-5.1%
September 11th	Sep 11-21, 2001	-14.3%	24.8%	-6.7%
Afghanistan War commences	Oct 5-9, 2001	-0.7%	12.4%	-16.8%
Iraq War commences	Mar 19 - May 1, 2003	2.3%	16.5%	22.0%
Madrid terrorist attacks	Mar 3-24, 2004	-2.4%	-0.1%	4.4%
Russia invades Georgia	Aug 8-16, 2008	-2.2%	-34.2%	-19.2%
Boston Marathon bombing	Apr 15, 2013	-1.8%	4.4%	11.4%
Russia annexes Crimea	Feb 20 - Mar 19, 2014	1.3%	7.8%	13.3%
North Korea tests ICBM	Jul 28 - Aug 18, 2017	-0.5%	TBD	TBD
	Average	**-2.4%**	**6.8%**	**7.8%**
	Average Gain	**---**	**12.4%**	**20.2%**
	% of Time Positive	**---**	**79.0%**	**57.0%**

Source: LPL Research, Ned Davis Research, FactSet Indexes.

-1.7%

The Market Drop during North Korea's testing of ICBMs from July 28 - August 18, 2017

A major military or terrorist crisis often disturbs markets in the initial days, but later the stock market (as measured by the Dow Jones Industrial Average) typically rebounds from the losses.

MARKET Insights

What's On Our Minds

We maintain a pro-growth stance in client portfolios, with overweight positions in US equities versus international stocks, and underweight positions in long-term government bonds versus inflation-indexed, high-yield, floating-rate and emerging market debt.

> *"Positive investment results in 2017 have been achieved with little volatility this year."*

Positive investment results in 2017 have been achieved with little volatility this year. The S&P 500 index returned **+11.9%** through the end of August and the market has exhibited only shallow corrections. The steepest decline this year was **-2.7%** from late March to mid-April. In our role as risk managers of our clients' wealth, we think often about scenarios that could cause markets to take another course from their current upward trends.

What Could Go Wrong

Volatility in long-term interest rates. We've seen a steady grind lower in long-term interest rates this year, in spite of accelerating US and global growth. Part of this is due to the decline in energy prices, which has tempered inflation expectations. Potential catalysts for higher interest rates include increasing global growth rates, rising wage pressures in a tightening job market and increases in core price inflation (for instance, from housing and healthcare).

Stretched US equity valuations. The US stock market (S&P 500) trades at around 22x trailing year earnings. Historically, the US valuation has been 16x. For the S&P 500 index to revert back to the long-term average valuation, prices could grow only **+1.6%** annually over the next 7 years, if earnings grow at their post-WWI rate of +6% per year.

Shrinking corporate credit yields. The extra yield that corporate bonds pay relative to US government debt ("credit spread") has declined substantially over the past two years. As recently as February 2016, high yield bonds offered a credit spread that was **8.87%** more than comparable government bonds. At the end of August the extra yield stood at just **3.85%**. Such a small incremental return is not attractive in light of the default risk that high yield bonds carry. We plan to reduce client allocations to high yield and emerging markets US-dollar debt. We will reinvest proceeds in intermediate-term US government, agency and investment-grade corporate bonds.

TO VIEW A MORE DETAILED DESCRIPTION AND ANALYSIS OF THESE INSIGHTS, VISIT WWW.WEBSTERBANK.COM/PB.

We hope you've found this commentary helpful. When you're ready to put these insights into action, visit www.WebsterBank.com/pb, contact your Webster Private Bank Portfolio Manager, or email us at pbinfo@websterbank.com.

Webster Private Bank®