A Rocky October

- Commentary on the Market Sell-Off - Growth Focus
- Our Main Investment Views - Stay the Course

The upcoming Fed tightening cycle has been the main factor behind the market sell-off earlier in September. This resulted in higher bond yields, a strengthening USD and more pronounced weakness in areas seen as suffering the most from higher interest rates - EM, REITs and commodities. Our portfolios were already positioned for a stronger dollar and a gradual increase in bond yields.

Over the past month, the focus has shifted away from Fed tightening towards yet another growth scare (as we have seen so many times since the recovery started in 2009). There are a few triggers for this renewed anxiety when it comes to the growth outlook:

- **Weak economic data in Europe**: In particular, a focus on Germany (PMI, export growth and capital goods orders). On October 14 Eurozone industrial production for August was released and it came down 1.8% for the month and -1.9% on a year over year basis.

- **European Central Bank (ECB)**: Hopes for a quick and robust implementation of securities purchases, specifically Asset-Based Securities (ABS) and covered bonds, are fading following the most recent comments by Mario Draghi. The first round of targeted LTRO (Long Term Refinancing Operations) was also below expectations. Investors are also increasingly worried about the release of the results of the Asset Quality Review later this month (and the potential for additional capital requirements and further de-levering by European banks).

- **International Monetary Fund (IMF)**: A recent report highlighting disappointing economic data and rising recession risks across the world, but in particular in Europe (up to 30%).

- **Lower growth**: Some intriguing or worrying market trends which seem to be consistent with lower growth going forward, e.g., sharp declines in commodity prices and cyclical sectors and renewed decline in bond yields (9 countries in Europe now have a negative 2-year Government bond yield - the US 2-year yield dropped 20bps in the past week and the 30-year yield crossed below 3%).

- **Fed minutes**: The Fed’s September meeting minutes seem to indicate a growing concern among FOMC members with regards to the softness seen in foreign economies.

At this point, and whatever the main cause behind the recent declines actually is, it is worth remembering that the last market correction happened three years ago (the S&P 500 was down 18%
between July and September). A 10% decline is typical during bull markets; what is not typical is for markets to go up in a straight line. The S&P 500 is down 7% from its recent highs but some other markets are already in (or very close to) correction territory, in particular commodities (down 16%), small caps (down 13%) and EM equities (down 11%) and European and Japanese equities have fallen +/- 9% from their recent highs (but are down more for USD investors given the currency weakness).

Equity bull markets typically end a few months prior to the onset of an economic recession (as this leads to a significant drop in corporate profits). While growth is disappointing and most economists have to again revise their expectations lower, we continue to see limited risks of a recession, either in the US (where growth is actually accelerating after the weakness experienced during the winter) or in overseas economies.

The silver lining to these developments comes in the form of a significant "tax cut" for businesses and consumers due to declining energy prices, lower mortgage and financing costs and a probable delay in the Fed’s first rate hike. Corrections also help take some of the froth and hot money from the markets and enable long-term investors to reposition their portfolios.

The obvious weak spot is Europe, but even there the most likely scenario is one where growth gradually recovers from current depressed levels. While the ECB has a tendency to react slowly to economic developments, they have nevertheless implemented and/or announced measures which should help boost economic activity going forward. The European economy has already suffered from a double-dip recession and triple-dip recessions rarely happen due to the existence of larger pockets of pent-up demand. Despite the recent turmoil, funding costs have stayed low and there is no sign of contagion in the credit markets. The sharp moves seen in European markets are also the consequence of investors’ most recent positioning (i.e. overweight Europe) and some are now throwing in the towel. While this trade has become very painful, we still believe that the downside risks for European equities are relatively limited (unless the region dips back into recession) and the upside potential is quite significant (if our baseline scenario of a pickup in bank lending leads to a gradual recovery in nominal GDP and a much more pronounced rebound in corporate earnings). The next important date will be October 26 when the ECB will release the outcome of its comprehensive review of the banking sector. Investors hate uncertainties, and being able to quantify the extent of the potential capital shortfalls should help improve sentiment towards the banking sector and the European economy. Over the past two years, European banks have already improved their capital adequacy levels to the tune of EUR 200 billion through a combination of equity and contingent convertible bonds issuance, retained earnings, asset sales, additional provisioning and other measures. This has negatively impacted economic growth in the region - as a result, a gradual reversal in bank lending (from a contraction to some level of growth) will greatly help reduce recession risks in Europe.

Our Investment Views

In the current context, it does hurt to maintain our current positioning but the fundamental outlook has not materially changed -- a sub-par global recovery, low inflation and ongoing accommodative monetary policies. At the margin, growth and inflation are trending slightly lower than previously expected and, as a result, monetary policies are probably going to stay a bit more accommodative. Unless we see a more pronounced deterioration of economic prospects (i.e. a material increase in recession risks), we will maintain our current investment strategy and use the most recent weakness as an opportunity to bring some portfolios closer to our recommended asset allocation. As a reminder, our portfolios remain positioned for a gradual improvement in global growth with an overweight position in equities and, within equities, an overweight stance in international markets. These markets are traditionally more sensitive to a pickup in economic activity and global trade. They also are more attractively valued and should benefit from more accommodative monetary policies in Japan, the Euro area and China. While we don’t expect bond yields to jump back to levels seen in previous economic cycles, we are nevertheless underweight duration given the very low bond yields seen across various sectors and markets - these yields can only move significantly lower in a recession scenario.

The good news is that, while we believe in the long-term opportunities offered by international equity markets, the investment team’s tactical implementation of these views has been slow and steady, based on client objectives. As a result, most portfolios are underweight to the markets most affected by the recent sell-off. While the S&P 500 is down +/- 5% over the past month, foreign markets are down substantially more. Volatility will be with us for some time, but in the end we believe that this volatility will prove to be a buying opportunity for long-term investors.

We will keep you informed on a regular basis if our strategy should change based on future developments, but for now, we stay the course and see the current selloff as the correction widely expected for the past few months.
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Most recently Cochez has held a number of senior investment positions across the globe with Deutsche Bank Private Wealth Management.

A native of Belgium, Cochez earned his Bachelor’s and MBA from the Universite Libre de Bruxelles, in Brussels, Belgium. He holds Series 7 and 66 Licenses and is fluent in three languages.