The Summer of our Discontent

Now is the winter of our discontent
Made glorious summer by this son of York.
– William Shakespeare, Richard III

Prior to the market open today, the S&P 500® is about 7.5% off its closing high in May. This decline has driven the year-to-date returns on stocks into the red and sparked concerns that this could be an ominous sign of things to come. This Market Update reviews our reasons for expecting market volatility in the second half of 2015 and how we believe investors should react to the recent market decline.

Our Expectation of Second-Half Volatility
Throughout the year, we have written in various publications about reasons why we expect financial market volatility. These volatility drivers include:

- upcoming Federal Reserve (Fed) rate hike;
- sharp decline in oil prices;
- global divergence; and
- longer than normal without a significant equity price decline.

According to our analysis, stocks tend to have a pullback in advance of the initial interest rate hike from the Fed, although stocks do tend to eventually recover. Certainly the market is struggling with settling the probabilities for the timing of the first hike. Futures last Monday, August 17, were indicating a roughly 50% chance of a hike in September and ended the week at about a one-in-three chance. Regardless of whether the Fed hikes rates in September as forecast by the PNC Economics team or later in the year, it seems highly likely that the first increase will come before year end. In any case, we think expectations of the first hike since the zero interest rate policy began in 2008, combined with the difficulty the markets are having timing liftoff, could both be contributing to the recent volatility.

Oil is now back at the lows of the year and not far from the financial crisis lows (Chart 1). We have noted that low oil prices can lead to volatility, since some of the negatives tend to be more short term while the benefits can take time to accrue. In addition, oil prices close to the crisis lows can lead some to believe that prices are signaling a significant downturn in the global economy and demand. Our

![Chart 1](Brent Crude Prices, December 31, 2007 to current)

**Source:** Bloomberg L.P., PNC
view is that oil supply is a significant cause in this case. Since lower oil prices are a benefit to net consumers of oil, consumers and economies of the United States, Europe, Japan, and China should all be net beneficiaries.

Our themes for 2015 included global divergence with some various economies of the world diverging from others, which we believe can be a cause of volatility as the financial markets react. In particular, we noted that China was likely to continue to see slowing growth. As the world’s second-largest economy, worries about a slowing China can and have spilled over into the financial markets beyond China. While PMI data for the United States are relatively strong, PMI readings for the global economy and China continue to be more troubling (Chart 2).

Until the significant pullback last week, the S&P 500 had gone more than three times longer than normal without even a 5% pullback. We note that the market has still gone close to six times longer than average without a 10% correction, and two-and-a-half times longer without a 20% correction. No one knows if this current market weakness will lead to a 10% or more decline, but history shows us that these painful declines are a normal if unpleasant part of investing in stocks.

Conclusion
There is no reason for us to believe that the current weakness in stocks portends any significant weakness or upcoming recession in the U.S. economy. In fact, recent data, including last week’s existing home sales, continue to point to solid economic growth in the United States. In addition, the U.S. stock market is a notoriously poor predictor of economic growth.

That said, we believe investors should be prepared for further declines in stock prices. This is not a forecast but rather a statement of fact that the market occasionally suffers more significant declines as a normal course of being the best-performing asset class over time. Neither we nor anyone else can accurately forecast the short-term behavior of stocks with any certainty. Consequently, investors should avoid reacting to these forecasts and work with their PNC advisors to focus on an asset allocation that matches their objectives and risk tolerance.

Beyond the recommendation to focus on goals rather than market timing, here are a couple of other actions to consider:

- **Rebalancing:** In our view, a systematic approach to asset allocation includes a periodic rebalancing process, whereby a periodic readjustment to a portfolio is necessary to maintain the targeted asset allocation. Over time, one asset class may outperform another in a meaningful way, moving the allocation away from intended targets. Rebalancing has been proven to lower risk and should thus increase the likelihood of investors reaching their investment goals. This simple process allows investors to buy low and sell high via a mechanical process, which also retains their intended risk target. While the impact to rebalancing for most investors would be a reduction in equities now that the S&P 500 level is almost three times the level of the 2009 low, we believe those investors underweight equities relative to their goals and risk tolerance should consider using the weakness to move toward their target weight.
Alternative investments: We believe the current market environment may warrant qualified investors considering a “New Simple Rule”—adding alternative investments to the simple periodic rebalancing process. Historically, after a significant bull market such as the one we have experienced, we think it would be appropriate for investors to rebalance some of these profits back to the safety of bonds. With bond yields remaining at such low levels, it seems unlikely to us that bonds provide the same safety as our past experiences. Our New Simple Rule portfolio of rebalancing a stock and bond portfolio along with alternatives showed quite significant positive results both in terms of performance and risk control during the period studied. In any case, adding alternative investments to a portfolio can help control some market volatility for appropriate investors.

While no one can know with any certainty what the short-term future holds, PNC believes that this summer of discontent will eventually lead to better times again, just as Shakespeare’s “winter of our discontent” gave way to a “glorious summer.”

Please see our July 2015 Investment Outlook, A New Simple Rule, for further information regarding the implication and implementation of alternative investments in portfolios. The August 2015 Investment Outlook, Midyear Outlook: Questioning the Bulls and Bears, gives more detail on many of items discussed here.

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