THE CYCLICALITY OF MARKETS

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August 2018

After lagging U.S. equities from 2012 through 2016, foreign markets had a huge boost in 2017, with the MSCI Emerging market index generating ~37% gains. 2017 was also the second year in a row during which all mainstream asset classes were positive. This was a fun result, especially for the disciplined and global investor, and one very few expected, given the geopolitical climate heading into 2017. And while investors may have hoped for the same events to transpire this year, an unusually strong dollar in 2018 coupled with the prospect of future rate hikes has foreign assets again lagging U.S. equities. This provided a stark reminder of the cyclical nature of markets and why it's important for investors to prevent their emotions from influencing investment-related decisions.

Ben Carlson, author of *A Wealth of Common Sense*, offers a great perspective on the inherent long-term cyclicality of global markets. It's hard for many to imagine, especially given the events of the last eight years, but since 1970, the MSCI EAFE (Europe, Australasia, and the Far East) has outperformed the U.S. in 25 out of 48 calendar years.

	MSCI EAFE	S&P 500
1970-1989	16.3%	11.6%
1990-2001	2.7%	12.9%
2002-2007	14.8%	6.1%
2008-2017	2.4%	8.5%
1970-2017	9.6%	10.5%

Source: Returns 2.0 i

Carlson comments, "The U.S. has outperformed over this entire period, but it's interesting to note that all of this outperformance has occurred since 2010. From 1970-2009, the annual returns were 10.2% annually for the EAFE and 9.9% per year for the U.S."

The emerging markets display an even greater contrast.

	MSCI EM	S&P 500
1988-1993	545.4%	128.7%
1994-1998	-38.5%	191.3%
1999-2007	420.1%	37.5%
2008-2017	21.76%	102.83%

"Going back to the inceptions of the MSCI EM Index in 1988, 76 percent of all annual calendar returns have been double-digit gains or losses. Also, almost half of all annual returns in that time were either gains or losses in excess of 20 percent." Notice the even greater disparity of returns with stomach-wrenching volatility.

These charts show that taking a concentrated position in the S&P500, MSCI EM, or the MSCI EAFE creates huge financial vulnerabilities. If he or she is wrong, an investor may lose upward of a decade of returns, plus the time needed to make back those opportunity costs.

Predicting exactly when the cyclicity of markets is likely to pivot is a near-impossible task. The one commonality in the reversal of market trends continues to be valuation: expensive assets eventually become cheaper, and cheaper assets eventually rise in value.

As difficult as it may be for investors to imagine a muted decade like the S&P 500's negative 1% annualized performance between 2000 and 2010 (especially after the recent performance of U.S. equities), they must remember that risk appetites often ebb and flow with valuations. Higher priced assets, albeit perceived as having a margin of safety, should inspire caution. The notion that our inherently biased narratives, selfishly motivated savings, and retirement timelines will be supported in a linear fashion is one of the more profound barriers to success – economic cycles and markets don't care about our personal lives and time lines.

Considering the world of investment opportunities today, one might expect US markets to continue their dominance but remain historically expensive compared to the mainstream foreign markets. Given the history of expensive markets eventually delivering subpar returns, many well-respected investors and investment firms have cautioned U.S. investors about maintaining their home bias. Even Vanguard recently joined the low-return chorus, cautioning savers about the 1-3% real returns over the next decade for U.S. equities.

Heeding this warning creates a conundrum for many investors. Should they maintain the overweight U.S. equity exposure, ignore history, and hope for the best or execute the infamous saying – buy low, sell high – despite the feverish anxieties of the limbic system when doing something counterintuitive?

We don’t pretend to be able to see the future, but we believe it’s integral for investors to be aware of the risks and potential implications associated with their decisions. There is a real possibility that U.S. markets will begin to deliver well-below-average returns at a time when many investors are beginning to feel like they’ve finally caught up from the last recession. Less expensive foreign markets show relative value but are known to deliver extremely high bouts of volatility, thereby shaking the resolve of even the most disciplined investors.

For those with a comprehensive plan, the cyclicality of markets is something to embrace. Opportunities stem from volatility, and 2018 is already on track to be the most volatile year we’ve seen since 2008.

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