Q&A: Financial market update. And the big shift we should all be talking about

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CEO Ted Truscott discusses the overall shift in financial markets, offers a practical outlook on trade tensions with China and has one word for 2019: diversification.

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Q: What's the big-picture shift that's occurring in financial markets and affecting investors' results?

Ted: I refer to it as a paradigm shift. The reality is, the cost of money is no longer zero. Think about it: over the last 10 years, the cost of money has effectively been zero — rates were so low, it was cheap to borrow money. But now, the markets are beginning to adjust to the reality that interest rates have been increasing. The Federal Reserve (the Fed) is trying to achieve a level of rates that doesn't hurt the economy while, at the same time, doesn't spark inflation. This notion of interest rate neutrality is both art and science, and it's what both the Fed and financial markets have been grappling with as the Fed tries to clearly communicate their plans and financial markets try to adapt. 2018 was unusual because both equities and fixed income had mostly negative returns. After almost three quarters of strong U.S. equity returns, the market ended the year with above-average volatility in the fourth quarter. These results had a lot to do with this big-picture shift in interest rates.

To appreciate this paradigm shift, we need to have some perspective. Coming out of the 2008 financial crisis, the Fed planned to take interest rates to a level that was so low, it effectively pushed people to invest in riskier assets. The idea was to reflate financial markets by discouraging investors from holding cash (cash became expensive because it didn't generate any return and effectively had the same opportunity cost as keeping it under your mattress). Investors were pushed to search for better returns from other asset classes. The result was one of the strongest and longest bull markets. So I think it's safe to say that their plan worked rather well.

Q: Is the return of interest rates good or bad news?

Ted: I think it's good news for all of us. I'm in favor of the Fed returning to positive interest rates and making sure we don't have another financial bubble. Over the last 15-20 years, the Fed has effectively bailed financial markets out every time there's been a problem. The Fed bailed out markets in 1998 as a result of the failure of Long Term Capital Management, again with the dot-com bubble in the early 2000s and after the financial crisis in 2008. I'm not arguing the responses weren't effective, but the Fed has set a precedent that financial markets can count on them to fix things when they don't go well. I'm not interested in another financial crisis in my lifetime (and I'm assuming you aren't either), so I believe the Fed needs to "take away the punchbowl when the party gets going." By that I mean they shouldn't keep using low interest rates as fuel for an economy that's sustainable on its own. We shouldn't be afraid of an economic slowdown. We shouldn't even be afraid of the possibility of a minor recession. I'll take that. Let's accept a slowdown. Let's make sure we let some air out of the financial markets rather than blow up in another bubble. With that perspective, I think this paradigm shift is a good thing.

Q: Trade tensions affected global markets in 2018 and caught up to U.S. markets more recently. What's your take?

Ted: Let's begin with basic economic principles: When you have two nations trading together, they're both going to be richer if they specialize in their competitive advantage. Over time, various countries have discovered their niches; global companies have set up global supply chains. It's become a very integrated world these days. And any interruption to that integration creates problems.

I think these issues can be resolved. There's no question that trade disputes are hurting China; China is probably more affected than the U.S., and other parts of the world are being somewhat harmed as well. China may be particularly sensitive to an economic slowdown because they need to meet the expectations of a new (and large) Chinese middle class. With that as context, I think the groups involved will make pragmatic decisions to help resolve the tension and curb unnecessary economic slowdowns.

In other parts of the world, you should pay attention to Europe as Brexit marches forward. If you include all the different participants in the European Union (EU), it's effectively the second largest economy in the world. The reality is, the greater eurozone is a very powerful element to world economy. March 29 is the big day when the U.K. will leave the EU, and exactly how events will unfold is still unclear.

Q: What should investors focus on?

Ted: A renewed emphasis on diversification across asset classes. Diversification hasn't really been crucial for most of the last decade. If you were invested in the S&P 500 Index, or even a balanced 60% equity/40% fixed income strategy, you benefited from equity returns, and you were just fine. I don't think that will be the case going forward. Diversification will matter more this year than any time in the last 10 years. In this kind of market, being well-diversified may be your best offense to reach return goals and best defense against volatility.

In equity, consider an approach that focuses on companies that pay dividends. It used to be that investors demanded a dividend just to compensate for the extra risk involved in stocks. But this faded as a priority over the last decade because stocks have had good returns even without a dividend. As we move forward, the importance of a reliable dividend is going to return as a priority. Dividends may be a larger percentage of total return in equities.

In fixed income, the market is offering a broad range of opportunities. For example, cnsumers have reduced their debt over the last decade and find themselves in a good position to pay it off. So, we find consumer-related debt sectors like mortgage debt that access this opportunity may be worth pursuing.

Q: How would you summarize the current market environment?

Ted: When markets are volatile, it’s more important than ever for us to communicate and for advisors and investors to talk and ask questions. I think we should all be discussing the paradigm shift that’s occurring as the Fed takes the punchbowl away from the party; interest rates are no longer zero, and it matters. It’s not a bad thing though – I’d take an economic slowdown over another financial crisis any day. This is just part of the process. Diversification is investors’ best foot forward in this environment.

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