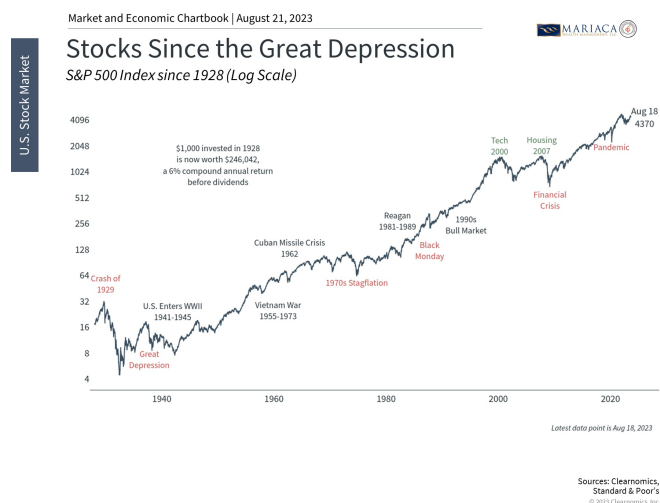


Why Investors Need Perspective Amid a Market Pullback, Fears Over China, and More

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Financial markets have pulled back in recent weeks due to factors such as rising interest rates and uncertainty in China. So far in August, the S&P 500 has declined 4.8% while the Nasdaq, which consists primarily of technology stocks, has fallen 7.4%. However, this is in the context of a strong rally from March through July during which the S&P 500 gained over 19% and the Nasdaq almost 29%. What's driving these market swings and what perspective do long-term investors need to stay balanced?

In the long run, the stock market has overcome even significant challenges



A perennial challenge for investors is distinguishing short-term issues from long-term trends. This is because, when it comes to investing, there are always reasons to be concerned. The last several years have been a parade of negative headlines including trade wars, the pandemic, supply chain problems, inflation, geopolitical risk, elections, debt ceilings, banking crises, bear markets, and many more. Even when these worries are resolved - or when they fall out of the news cycle - they are always replaced by seemingly more urgent issues. Unfortunately, it appears to be human nature for investors to constantly shift focus from one set of problems to another,

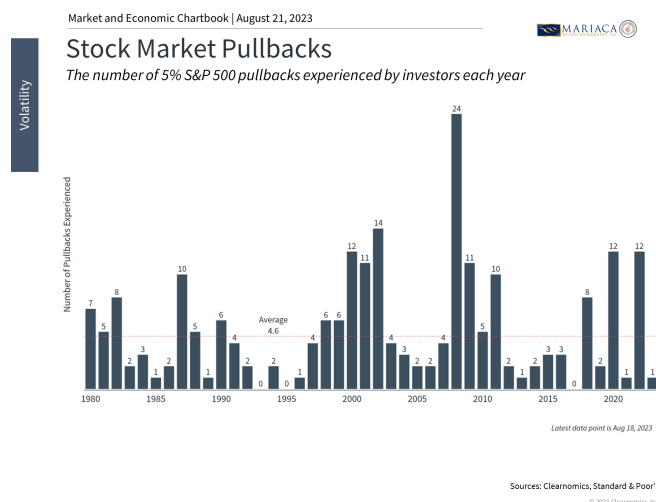
creating an endless hamster wheel of anxiety.

Despite this, financial markets have experienced many periods of strong returns, especially when considering longer time frames. As the accompanying chart shows, the market trend over the past century has been one of long-term wealth creation driven by economic growth and technological advancement. Zooming in, there are countless periods during which investors grappled with wars, recessions, financial crises, and other once-in-a-generation issues. But even when the market stumbled, the new lows were often higher than prior peaks. With the benefit of hindsight, those who were saving for goals such as retirement, buying a home, or college, would have been best served by focusing on years and decades, not months and quarters.

This perspective matters because the market is once again experiencing a period of volatility after a robust rally. What are the primary sources of concern today? First, interest rates have jumped over the past month. The 10-year Treasury yield has risen above 4.25%, the highest level since 2007. This has coincided with events such as Fitch Ratings downgrading U.S. Treasury securities and Moody's downgrading many banks. This has forced other interest rates higher, including the average 30-year mortgage rate which is now above 7%, the highest since 2000.

Just as they did last year, rising rates have acted as a headwind on the broader stock market and tech stocks in particular. Many of the best performing tech stocks, which also happen to be the largest stocks in the S&P 500, have struggled as a result. Some company-specific factors, such as weaker-than-expected earnings due to softer demand, have acted as a drag as well. These rate moves could also have a mixed impact on the economy. Higher long-term rates tend to slow the economy by increasing the cost of capital. At the same time, the yield curve has steepened which may be viewed as positive, especially if it helps to slow inflation further.

Despite how some investors may feel, the stock market has been calm



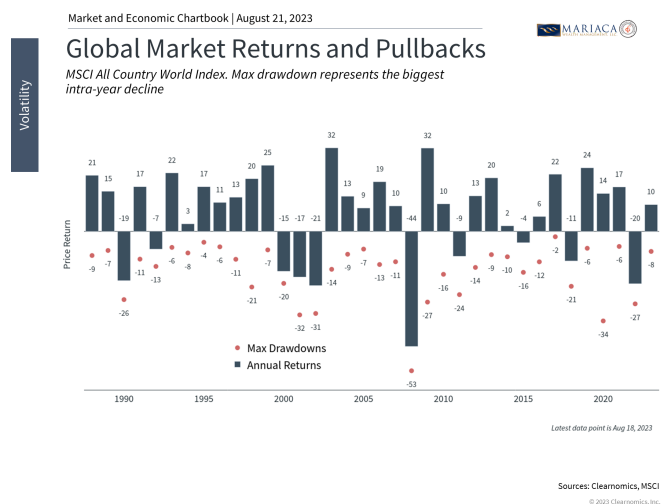
The accompanying chart shows that despite the current pullback, which is just under 5% so far, the market has been quite calm compared to the average year. Most years experience several 5% intra-year declines, and the worst years experience about a dozen. The last one occurred during the banking crisis earlier this year before the situation stabilized and tech stocks resumed their leadership. This shows that the market is often not as volatile as it may seem, especially when it is driven by natural dynamics such as the ebb and flow of interest rates.

Second, concerns over slowing economic growth in China coupled with a long-simmering debt crisis have reemerged. Investors have worried about a "China hard landing" since at least 2010 as the country's growth rate has slowed. From 1980 to 2010, Chinese real GDP grew by 10% per year - a remarkable pace as it caught up to the rest of the world. The most recent official data suggest that growth has decelerated to 6.3% year-over-year, a rate that is slower but that still outpaces most of the world. There are other signs that consumer spending and industrial production are slowing as well, in addition to signs that unemployment, especially among youths, is higher than previously expected.

The term "Lehman moment" appears every few years over the property market and the "shadow banking system" in China. Two years ago, the Chinese property developer Evergrande faced a liquidity crisis leading to widespread market concerns (it has now filed for bankruptcy). More recently, Chinese companies such as Zhongrong International Trust and Country Garden Holdings, both large private companies, both missed bond payments. Some see this as the culmination of the rapid growth and slowdown in China that created imbalances over the past two decades.

This situation is still playing out but previous episodes show how difficult it is to predict the outcome of financial instability in China, even if there are signs of bubbles. China's command-and-control economy gives it tools to control a crisis, up to a certain limit, even without bailing out defaulting entities. Of course, economic theory suggests that this only kicks the can down the road, but it's unclear where the road ends. In the meantime, China must try to shore up its currency which has depreciated against the dollar in recent weeks. At the same time, a weaker yuan can be positive for economic growth if it helps to spur export activity.

Global stocks have generated strong returns this year



While investors may be concerned about these issues and their repercussions across markets, these risks are exactly why investors are rewarded in the long run. Despite recent market volatility, emerging markets have contributed significantly to diversified portfolios over the past twenty years. Investing in China and EM requires accepting a large degree of uncertainty but this is ultimately what drives long run returns. The chart above shows that global markets, which includes the U.S., developed international, and emerging markets, can experience significant intra-year declines. Despite this, most years experience positive returns, benefiting those with the fortitude to stay invested.

Thus, while every market pullback is challenging and each new situation feels unique, the reality is that diversified portfolios tend to stabilize and recover regardless of the underlying causes. Rising rates are a headwind for markets, just as they were last year. The problems in China are large in scale, but investors have been watching closely for signs of trouble for over a decade. Understanding these events, while not overreacting to every headline, is the key to maintaining balance and focusing on long-term financial goals.

The bottom line? Investors ought to maintain perspective and stay diversified through periods of market uncertainty, whether due to rising rates, China, or other concerns.

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