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3 Lessons for Investors From Recent Market Drama

On display in the third quarter of 2024: the volatility inherent to equities, the benefits of asset-class diversification, and the dynamism of markets.

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Will third-quarter 2024 stock market volatility register as a mere blip on investment growth charts? Or will it be remembered as an inflection point? Only time will tell who's right: bears heralding the bursting of the artificial intelligence bubble or bulls who say the market is just "climbing a wall of worry." Pessimism tends to sound smarter. But it's the optimists who've been repeatedly vindicated in recent years.

What's clear is that the cycle of greed and fear has been turning. AI enthusiasm, which pushed the Morningstar US Market Index to a 44% gain from the start of 2023 through the midway point of 2024, gave way to jitters over the economy and equity prices. Jobs reports, inflation prints, and earnings announcements caused selloffs. Both an unexpected interest-rate hike by the Bank of Japan and an expected rate cut by the US Federal Reserve contributed to volatility.

Though equities have ridden out the bumps to post healthy gains this year, signs of change are visible beneath the surface. Value stocks are beating growth in the third quarter. Small caps have rallied. The Morningstar Global Markets ex-US Index is even with its American counterparts in dollar terms since July 1. High-quality fixed-income assets have thrived. The Morningstar US Core Bond Index is up more than 5% in the third quarter.

Whatever the future holds, recent market drama holds lasting lessons for investors:

1) The market is going to fluctuate.
2) Diversification isn't dead.
3) There is nothing permanent except change.

1) The Market Is Going to Fluctuate

According to investment lore, John Pierpont Morgan once responded to a request for a forecast with: "Young man, I believe the market is going to fluctuate." Whether Morgan or anyone else actually said it is beside the point. The quote speaks both to the futility of investment forecasting and the volatility inherent to equities. It can also serve as a timely reminder.

Bull markets foster complacency. The Morningstar US Market Index, a broad gauge of equities, climbed 26% in 2023 and then gained another 14% in the first half of 2024. Ever since the launch of ChatGPT in late 2022, market enthusiasm around artificial intelligence has driven heady gains in stocks like Nvidia, Microsoft, and Meta Platforms. When markets are setting fresh highs, expectations grow unrealistic. Investors forget that stocks can go down. The 20%-plus drawdowns of 2022 and 2020 fade from memory.

Investor sentiment can turn on a dime. In early July, the Morningstar US Market Index rode momentum that was bolstered by strong corporate earnings reports and expectations for interest-rate cuts. Then came a wobble on July 17, seemingly prompted by concerns over trade policy hurting semiconductor makers. The narrative began to shift. Fears over a narrow and pricey market set against the backdrop of macroeconomic and political risk took hold. Earnings from Tesla and Google-parent Alphabet added to the jitters. On July 24, the Morningstar US Market Index dropped 2.3%, a one-day decline not seen since 2022. August brought news that Berkshire Hathaway sold half its stake in Apple. A weak US jobs report raised recessionary fears and concern that the Fed had kept borrowing costs too high for too long. Then the Bank of Japan surprised markets by hiking rates. Risk assets sold off globally.

It's said that "in a crisis, correlations go to 1." That was certainly the case on Aug. 5. Across investment style, size, and geography, there was no place for equity investors to hide, as displayed in Exhibit 1. All nine Morningstar Style Box indexes fell. The Morningstar US Market Index lost 3%, while the Morningstar Japan Index fell 12%.

Exhibit 1 Equity Market Segments: No Place to Hide Across Style, Size, and Geography on Aug. 5, 2024

	Value	Core	Growth
Large	−2.34	−2.68	−2.80
Mid	−2.46	−2.43	−2.35
Small	−2.97	−2.84	−2.65

Source: Morningstar.com. Data as of Aug. 5, 2024.

Technical factors undoubtedly contributed. The issue with the Bank of Japan's rate hike was that it prompted an unwinding of the "carry trade"—the practice of borrowing cheap Japanese yen to fund other assets. When investors enter a state of "deleveraging," selling can become indiscriminate. Vicious cycles take hold. Perhaps the downturn's timing—when many traders in the US and Europe were on summer vacations leaving juniors to staff their desks—compounded losses.[1] Liquidity was lacking.

While stocks rebounded in August, early September brought more pain. Nvidia beat earnings estimates, but not by enough. While stocks have recovered since then, even hitting fresh highs after the Fed's Sept. 18 rate cut of 0.50% was digested, volatility levels have spiked. As displayed in Exhibit 2, the Morningstar US Market Index's standard deviation of returns (a measure of volatility) has increased to levels not seen since 2022.

Exhibit 2 Stock Market Volatility: A Spike in the Third Quarter of 2024

Source: Morningstar Indexes. Rolling 90-Day Standard Deviation of Returns (Annualized) for the Morningstar US Market Total Return USD.

In the context of the past five years, though, third-quarter 2024 volatility has been modest. Equity prices bounced around far more in 2022. The most severe was in March 2020 when the "pandemic panic" roiled markets, even triggering a one-day loss of 12%.

Does it even matter if the market fluctuates? "Volatility isn't risk," savvy investors are fond of saying. "Risk is the permanent impairment of capital." The issue with volatility is that it amplifies the fear and greed cycle. Investors are prone to buy volatile investments high and sell them low.

Morningstar quantifies this effect by calculating "investor returns," adjusting funds' performance for collective purchases and sales. The Mind the Gap study measures the difference between posted returns and the actual investor experience. According to the 2024 edition, "The more volatile a fund's returns versus peers, the larger the gaps tended to be."[2]

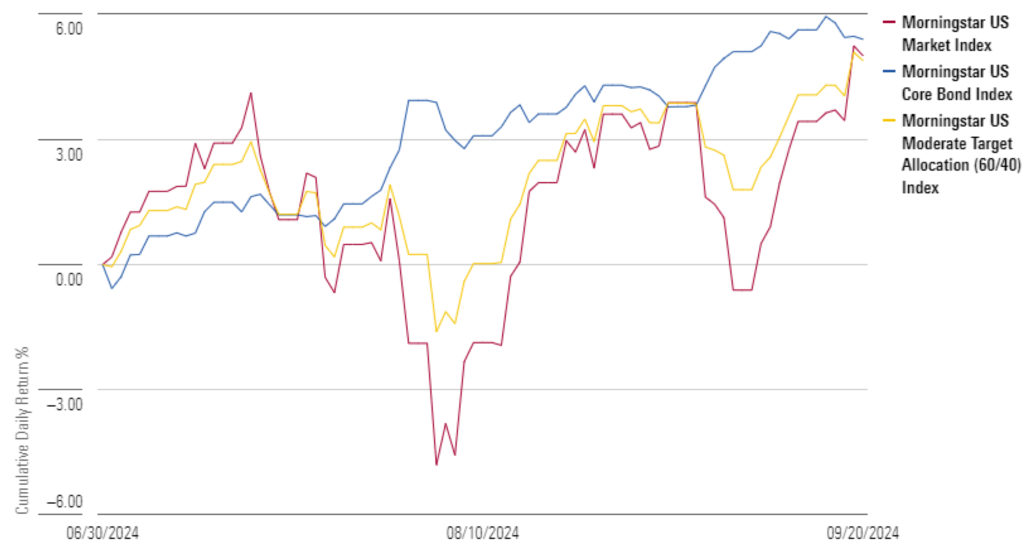
1 Steer, George. Did summer holidays make this week's market turmoil worse? *Financial Times*. Aug. 9, 2024.

2 Ptak, Jeffrey. Mind the Gap 2024. Morningstar. Aug. 15, 2024.

2) Diversification Isn't Dead

"Bonds are so back," wrote Jason Kephart of Morningstar Research in August.[3] While equities were hitting the skids in the third quarter of 2024, the Morningstar US Core Bond Index climbed. The 10-year US Treasury yield fell, and bond prices rose, benefiting from a flight to safety and from expectations of interest-rate cuts. Multi-asset investors have seen diversification pay off. The Morningstar US Moderate Target Allocation Index, which represents the traditional mix of 60% stocks and 40% bonds, preserved capital better than an all-equity portfolio during the third-quarter selloffs.

Exhibit 3 Third-Quarter Performance for Stocks, Bonds, and Multi-Asset: Bonds Have Diversified Equity Market Losses



Source: Morningstar Direct. Gross Returns in USD for Morningstar Global Factor Indexes. Data as of June 30, 2024.

Why is this noteworthy? After all, bonds are often referred to as "portfolio ballast." Yet, it was not long ago that fixed income failed to play its traditional role of steadying the ship, mitigating losses during equity market selloffs. In 2022, investors suffered through what Morningstar's John Rekenthaler termed the "worst bond market ever"[4] thanks to generationally high inflation and the most rapid and severe monetary policy response in 40 years. Stocks and bonds fell in lockstep. Headlines proclaimed the "death of diversification" and the "end of the 60/40 portfolio."

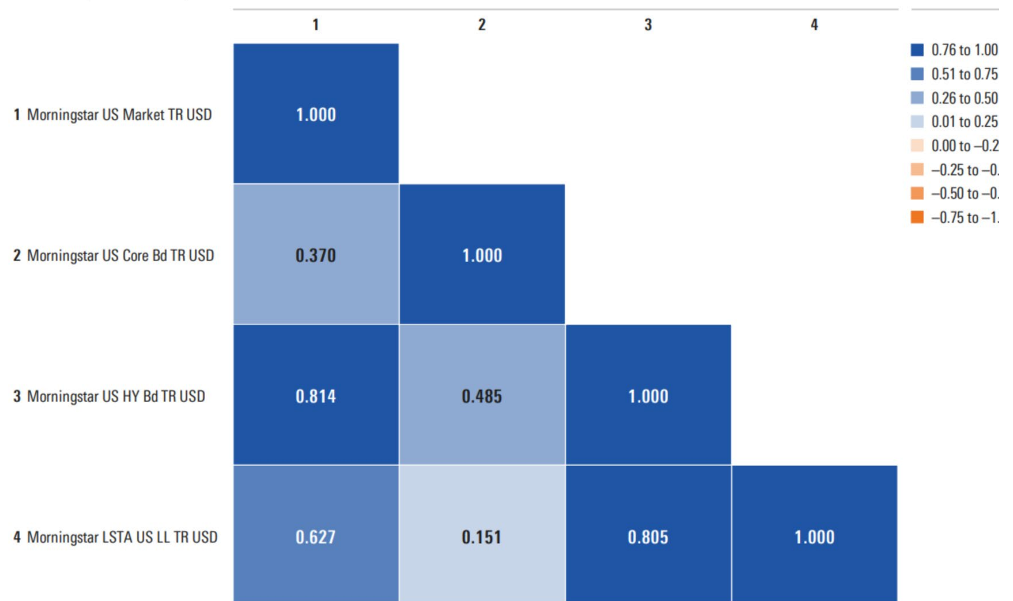
Investors who had come to expect bonds to rise during bear markets for stocks were deeply disappointed. Unlike the "pandemic panic" in the first quarter of 2020, the global financial crisis of 2007-09, and the aftermath of the dot-com bubble in 2000-02, the Morningstar US Core Bond Index failed to rise as stocks fell in 2022. As a result, the Morningstar US Moderate Target Allocation Index declined nearly as much as an all-equities portfolio in 2022.

3 Kephart, J. The 60/40 Portfolio: Bonds Are So Back. Morningstar. Aug 12, 2024.
4 Rekenthaler, J. The Worst Bond Market Ever. Morningstar. Nov. 21, 2022.

According to Morningstar research, inflation and rising interest rates cause correlations between stocks and bonds to rise.[5] The two asset classes moved together during inflationary episodes soon after World War II, in 1966-70, then 1977-80. But inflation stayed so benign for so long thereafter that few investors were prepared for its reappearance in 2022. Interest-rate hikes intended to combat inflation wreaked havoc on both major asset classes that year. Meanwhile, commodities-related assets, linked to a key inflation driver, rose in 2022. The Morningstar Global Upstream Natural Resources Index gained more than 15%. This is consistent with the history of other inflationary periods.

While the stock/bond relationship seems back on track in the third quarter of 2024, it's important to note that fixed income isn't a monolithic asset class. The high-quality, interest-rate sensitive Morningstar US Core Bond Index benefited from a flight to safety and expectations of monetary loosening, but fixed-income segments with lower credit-quality profiles and greater sensitivity to the economy did not. The Morningstar US High Yield Bond Index and the Morningstar LSTA US Leveraged Loan Index have behaved more like equities this quarter. That is not unusual from a historical perspective. As displayed in Exhibit 4, over the past 10 years, high-yield and bank loans have been more closely correlated with stocks than with high-quality core bonds in the US.

Exhibit 4 Correlation Matrix: High Yield and Leveraged Loans Move More With Stocks Than High-Quality Bonds



Source: Morningstar Direct. Correlation matrix for the 10 years through Aug. 31, 2024.

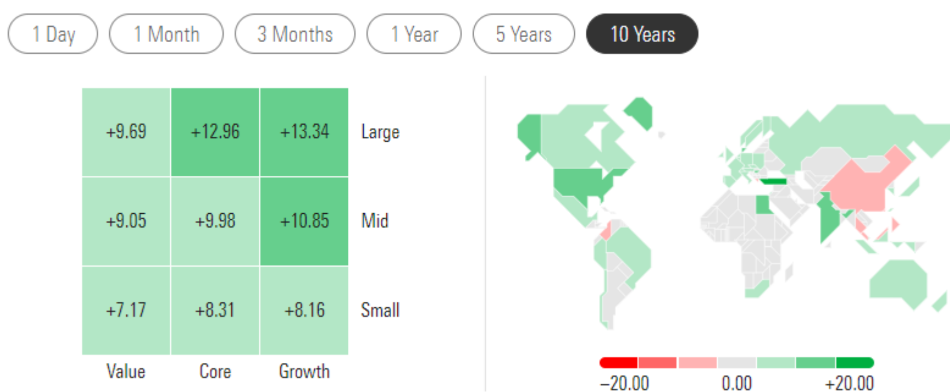
Investors have learned that correlations are dynamic. The relationship between stocks, bonds, and other assets is constantly in flux. In down markets for stocks, high-quality, interest-rate-sensitive bonds have often acted as shock absorbers. In inflationary periods, this relationship breaks down; the more economically sensitive fixed-income areas behave more like equities.

5 Arnott, A. How Rising Interest Rates Change the Relationship Between Stocks and Bonds. Morningstar. April 23, 2024.

3) There Is Nothing Permanent Except Change

As discussed above, correlations can go to 1 in crises. But over the long term, market segments can diverge dramatically. For more than 10 years, growth stocks have outperformed value; large caps have beaten small; and the US has been the place to be for equity investors. As displayed in Exhibit 5 below, the Morningstar US Market Barometer shows a massive differential between the top-performing large-growth market segment and the laggard—small-cap value. Despite academic research supporting a long-term performance advantage for small-cap value, tech themes like mobile computing, the cloud, and AI have continued to power large-growth stocks. From a geographic perspective, the Morningstar US Market Index's 10-year performance lands it in dark green territory, while China, the world's largest emerging market, has produced negative returns. Collectively, equities outside the US have badly lagged, especially from the perspective of dollar-based investors.

Exhibit 5 Equity Market Segments: Dramatic Divergence Over the Past 10 Years



Source: Morningstar.com. Data as of Sept. 17, 2024.

In 2023 and the first half of 2024, highly profitable "quality" stocks, mostly larger cap and with a growth bent, dominated. While the "Magnificent Seven" of Apple, Microsoft, Nvidia, Alphabet, Amazon.com, Meta Platforms, and Tesla reigned supreme, the value side of the market and smaller caps languished. Morningstar factor indexes focused on value, yield, size, and low volatility lagged quality and momentum.

"Rotation" is a term that has trended throughout the third quarter. Whether viewed through the lens of the Morningstar Style Box, sectors, or investment factors, equity market leadership has changed. The Morningstar Global Markets ex-US Index has outgained its US counterpart in the third quarter, with the Morningstar Emerging Markets Index up even more. Value has beaten growth. Small caps have outperformed. Morningstar's low-volatility factor index has performed best, followed by size, yield, and value. In contrast to the first half of the year, quality and momentum are bringing up the rear.[6] As displayed in Exhibit 6, sector dynamics have shifted markedly.

6 For more on this topic, see: When Market Direction Changes, So Does Factor Leadership.

Exhibit 6 Equity Sector Performance: Leadership Changed in the Third Quarter of 2024

Sectors	2024 - First Half Return %	2024 - Q3 Return %
Cyclical		
Basic Materials	1.71	7.10
Consumer Cyclical	2.85	8.31
Financial Services	10.28	10.53
Real Estate	-2.43	16.31
Sensitive		
Communication Services	25.31	-0.03
Energy	10.76	-2.57
Industrials	7.15	8.90
Technology	25.97	0.66
Defensive		
Consumer Defensive	8.72	7.55
Healthcare	7.25	6.79
Utilities	9.64	17.95

Source: Morningstar Direct. US Sector Indexes in Total Return USD Terms. Returns through Sept. 20, 2024.

Will the rotation persist? Investors will be reminded that this is not the first time over the past decade that signs of regime change have manifested. In 2016, the election of Donald Trump as president sparked a ferocious rally in US small-cap value stocks in sectors like financials, basic materials, industrials, and energy. They were perceived beneficiaries of a platform of tax cuts, regulatory rollbacks, turbocharged economic growth, and protectionism. Technology stocks sank on the election of a candidate perceived to be hostile to Silicon Valley.

But the "Trump Bump" was ultimately a head fake. By 2017, large-cap growth was back on top, as key planks of the agenda, such as infrastructure spending, failed to advance. Technology was the best-performing sector over the four years of Trump's presidency.

Another seeming inflection point came in 2022. As discussed above, it was the year that inflation went from "transitory" to "sticky" and the Fed jacked up rates by a total of 4.25 percentage points in response.

The technology sector, which benefited so much from the pandemic, led the market down. Value stocks, boosted by the energy sector (Russia's invasion of Ukraine sent oil prices soaring), led the market, as did defensive areas like healthcare. But the launch of ChatGPT in late 2022 brought growth stocks in general, and the technology sector specifically, back in a big way. The rotation of 2022 was ultimately fleeting.

Over the long term, though, market leadership is highly changeable. To paraphrase an axiom, the degree of change is often overestimated in the short term but underestimated in the long term. After the dot-com bubble burst in 2000, value and smaller caps trounced growth for years. Skepticism toward the technology sector and investing based on techno-growth trends was ubiquitous. A commodities "super cycle" fueled by China's expanding economy drove financial markets globally in the early 2000s. US equities experienced a "lost decade," while emerging markets and European shares outperformed.

Consider that in 2009, the US stocks represented 40% of the Morningstar Global Markets Index weight (it's now well over 60%). The energy sector represented more than 10% of global equity market value 15 years ago (it's now closer to 4%). Few predicted US equities and the US dollar would so thoroughly dominate the era following a crisis that originated in the American housing market and financial system. How many expected the technology sector to reach such heights back when the FANG acronym—for market darlings Facebook, Amazon.com, Netflix, and Google—was first conceived back in 2013?

Don't Predict. Prepare.

So, what's an investor to do? Divining market direction over the short term is extremely difficult. It can also be vexing over longer periods. The era of dominance for US large-cap growth stocks has lasted far longer than many have expected. It has given life to many thematic strategies.

On the flip side, several cohorts have been frustrated. Emerging-markets enthusiasts, believers in the value effect, and small-cap investors have all underperformed—badly. Dividend-focused investors have failed to participate fully in equity market gains because of the outperformance of the fast-growing, dividend-light section of the market.

Diversification is always a sensible approach in the face of uncertainty. Portfolios should be ready for a range of scenarios. Equities outside the US could outperform, value stocks may beat growth, and small caps could go on a winning streak. Today's healthy bond yields are a better starting point for future fixed-income returns than they were during the years of ultralow interest rates following the financial crisis. Natural-resources-related investments, for their part, have shown they can enjoy days in the sun. Because the future rarely resembles the past, the case for holding a broad set of assets is strong. M

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