MARKETS

Stocks' Return to Records Paves Way for Volatile Autumn

Overall economic outlook bright, but markets have history of wobbling in September

Good times: Traders Andrew Silverman, left, Gregory Rowe, center, and Robert Charmak share a laugh Friday as they work on the floor of the New York Stock Exchange. PHOTO: RICHARD DREW/ASSOCIATED PRESS

By Akane Otani

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U.S. stocks are back at all-time highs after a dizzying August rally, prompting some investors to fear a reckoning heading into what historically has been a weak stretch for markets.

Few would dispute that the general outlook looks bright. Inflation, which investors earlier in the year had feared would stall the economic expansion, has plodded along at a benign rate. Corporate earnings are growing at the second fastest pace since 2010. Even the threat of a trade war has appeared to dim in recent weeks, with the U.S. and Mexico reaching a trade agreement in late August after months of tense negotiations.

Yet many investors, burned by previous snapbacks, can't help but view September with a degree of apprehension.

Global-fund managers are holding higher-than-average levels of cash in their portfolios. Shares of utilities and real-estate firms, considered bond-like because of their dividend payouts, have started to rebound over the past couple of months. And firms including Morgan Stanley and RBC Capital Markets have recommended unloading technology stocks, the best-performing S&P 500 sector in 2018.

Fall has often been a volatile stretch for global markets. Stocks tumbled in 2017 after North Korea-U.S. tensions ratcheted higher, lost ground in 2016 as investors questioned central bank-policy and fell in 2015 when the global economic expansion appeared to stall. The phenomenon is far from new: Going back to 1945, the S&P 500 has notched its worst monthly return in September, followed by February and then August, according to investment research firm CFRA.

The prospect of a market jolt is keeping even optimistic investors and analysts guarded.

"Traditionally this is a season of a lot of volatility and uncertainty to begin with, and we certainly have the ingredients to experience that," said Katie Nixon, chief investment officer of Northern Trust's wealth management business. "Things are getting a little bit tougher from a relative perspective as we get into 2019."

Part of investors' uneasiness stems from the speed and scale of the stock market's gains over the past few weeks.

After languishing in a narrow range for seven months, the S&P 500 has broken out to fresh highs, climbing 3% in August and ending its longest streak without a record close in two years. The tech-heavy Nasdaq Composite has risen even faster, advancing 5.7% last month to post its biggest gain for August since 2000—the year when the dot-com era peaked before skidding to an end.

Many investors have also grown increasingly worried that much of the stock market's gains have been driven by just a handful of large technology companies, including Apple Inc., Google parent Alphabet Inc. and Amazon.com Inc.

"It's starting to hark back to the 2000s," said Mark Senseman, chief investment officer at The Wealth Consulting Group, adding that, even with strong earnings, valuations on many technology companies "are getting frothy."

The pace of the gains, as well as that much of it came on relatively low trading volumes, has left some investors wary of a possible pullback.

"It makes you wonder what happens when summer vacation is over and volumes finally show up," Mr. Senseman said.

Others worry that, with global trade negotiations still in flux, investors may be caught off guard by an unexpected breakdown in talks. Even as trade fears have spurred selling in markets across Asia and Europe, the U.S. has held up relatively well—something some analysts worry points to complacency among investors. The S&P 500 is up 8.5% for the year, compared with the Shanghai Composite's 18% fall, the Stoxx Europe 600's 1.8% decline and the Hong Kong's Hang Seng Index's 6.8% fall.

"For the most part, the U.S. has brushed aside trade concerns, which means if this escalates, we could see an asymmetric reaction to this," said Jason Draho, head of Americas asset allocation at UBS Global Wealth Management's chief investment office. "With emerging markets, China--more of it has been priced in."

Then there is the recent softening in the U.S. housing market, which has cast a pall on an otherwise bright economic picture. Sales of existing homes have fallen for four consecutive months, the longest such streak in five years. The dropoff is a troubling sign to many analysts, especially because the housing market is considered an indicator of the U.S. economy's overall health.

Meanwhile, global fund managers are holding an average of 5% of their portfolios in cash, the highest share since April, when a number of the year's best-performing technology stocks fell into a rout, according to Bank of America Merrill Lynch.

To be sure, few believe the U.S. is on the precipice of a recession. Data still show strong second-quarter economic growth, consumer confidence tracking at nearly 18-year highs and consumer spending ticking higher.

And analysts are heartened that measures of investor enthusiasm, while on the rise, have remained off the highs they hit at the start of the year. Roughly 44% of individual investors expect the stock market to rise over the next six months, above the historical average of 39% but still below the 60% that said so when global stocks were catapulting to records in early January, according to the American Association of Individual Investors' weekly survey.

That is reassuring for those who believe that elevated levels of investor enthusiasm are a sign of a market "melt-up," a surge in prices driven by a fear of missing out on a rally, rather than optimism over corporate earnings, valuations or economic data.

Yet with a number of potential risks on the docket—including midterm elections, further trade negotiations between the U.S. and China and a Sept. 30 deadline for a new federal budget—investors say they are mentally preparing for more market swings.

“Sometimes it feels like you have a handle on [market risks] in the morning, and then whether it’s a tweet or a comment, you have to rethink your own base case,” Ms. Nixon said. While she remains optimistic overall, Ms. Nixon added that she is bracing for a pickup in volatility.

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