Risk off Versus Risk on

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Last Week's S&P 500 Index:
+1.9%

Key takeaways

» *From the September 20 record high in the S&P 500 Index through the Christmas Eve close, stocks took on a "risk-off" tone.*

» *However, as equities have bounced higher over the last two weeks, "risk-on" sectors have outperformed.*

The recent extreme volatility on display in the stock market has struck fear into the minds and hearts of many investors (and maybe even some equity strategists). It took slightly more than three months for the S&P 500 Index to fall a whopping 20% from the September 20 record high to the close on Christmas Eve. And if you think that sounds extreme, consider that the index notched 16% of that loss in just the three weeks leading up to the close on December 24. And to think, on December 3 we traded inside of our long-held 2018 year-end target range. Frustrating to investors and equity strategists alike.

But the resulting bounce higher in stocks has been almost just as violent. The S&P 500, at the time of this writing, is nearly 12% higher than the Christmas Eve close. The index ended the year down 4.4% (including dividends) after sporting a 22% total return in 2017. It might help the psyches of investors to realize that the market ended down a rather modest amount and the two-year return has actually been quite good.

You often hear the phrases "risk off" and "risk on" when the financial media are commenting on action in the markets. A risk-off market is one where investors run for cover, moving funds to what are often considered "safe havens" during uncertain times. In the stock market, risk off typically means moving money into larger-capitalization equities in sectors that are at least somewhat insulated from fluctuations in the economy and economic-growth fears. Think of sectors such as Utilities and Consumer Staples. Investors often flock to these sectors in times of stress because their services and products are used whether the economy is good or bad. You turn on the lights and take a hot shower no matter what the economy is doing (Utilities). Likewise, you purchase toothpaste, deodorant, and laundry detergent whether economic growth is good or bad (Consumer Staples).

In a risk-on market, funds flow to sectors dependent on economic growth, such as Consumer Discretionary and Industrials. A growing economy, high confidence, and a good labor market typically fuel increased consumer spending on discretionary items like cars and furniture as well as business spending on equipment.

From the September record high in the S&P 500 thru the Christmas Eve close, the stock market had a risk-off tone with Utilities and Consumer Staples being among the top three best performing sectors on a relative basis. Investors were looking for places to hide as stocks dropped. But since trading resumed on the day after Christmas through the early part of this week, the equity market took a risk-on mentality with the Consumer Discretionary, Financials, and Industrial sectors being among the outperformers.

Whether the stock market is risk-on or risk-off comes down to whether investors are hiding and fearful or assertive and confident.

Risk Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

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