

Stocks in 2019: Volatility Is Back

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Volatility is back.

It was easy to forget how downside pain in equities could feel given robust growth over the last decade—and especially the two years ending January 2018. Robust corporate profits and a benign interest rate environment meant that prices of risk assets climbed unabated with only mild, short-lived pullbacks.

Headwinds for 2018 included a re-establishment of actual income and returns offered by the “risk-free” Treasury assets as the Federal Reserve (Fed) hiked rates, and fears over a global trade war were spiraling out of control. In our view, these issues are well known and increasingly priced into market valuations.

We will soon find ourselves a decade from the bear market lows of 2009, in one of the longest economic expansions since World War II. It is natural to worry about being late cycle in both the economy and the equity markets. Many are also worried that extended valuations imply poor forward returns. We are less concerned about the market generally, but there are pockets of caution—they just may not be where you'd expect.

In the fourth quarter of last year, there was a dramatic rotation away from momentum stocks—technology—toward more defensive, dividend and lower-volatility stocks.

When our team evaluates valuations across common factors, low-volatility stocks across the United States look the most extended. The MSCI USA Minimum Volatility Index has P/E ratios that are a few points higher than the [S&P 500](#), despite this segment of the market being concentrated in slower-growing, lower-profitability companies.

Despite volatility picking up and a natural desire to lower equity exposure, there is a hidden risk to this very popular and “crowded factor.” This “low-vol” factor performed the best in 2018, outperforming the market by over 500 basis points through mid-December. We'd be more cautious looking forward, despite the worries of rising volatility.

In terms of asset allocation strategies, our three favorite exposures to the U.S. markets for 2019 offer compelling valuations and are well positioned for rising volatility. Those three funds are the following:

- [DGRW: WisdomTree U.S. Quality Dividend Growth Fund](#)
- [USMF: WisdomTree U.S. Multifactor Fund](#)
- [EES: WisdomTree U.S. SmallCap Earnings Fund](#)

The weighted averages of these three exchange-traded funds currently sell at 14x forward earnings and are of a general higher quality than most, with a 22% return on equity (ROE).

Quality at a Reasonable Price: While there are concerns that quality stocks are expensive, DGRW's approach shows lower forward-looking valuations than the S&P 500, with a meaningful improvement in ROE profitability gauges. We continue to prefer that trade-off.

Similarly, with EES's P/E ratio of less than 11x for trailing and estimated 2019 earnings, we believe fears of overvaluation in equities can be managed with this basket of 900 stocks.

Finally, USMF continues to add value through the combination of fundamental as well as technical screening factors. We believe we will see a continuation of its strong returns with reduced volatility compared with broad market benchmarks.

International markets bore the brunt of investor angst and selling in 2018. We still generally favor the U.S. over Europe. But we also suggest more over-weight positions in Japanese small caps, which benefit from low valuations, improved corporate governance impacting shareholder returns and generally lower correlations with U.S. markets.

Emerging markets, which tend to perform well when global growth accelerates, were down in lockstep with Chinese markets. We recognize it will be difficult for emerging markets to outperform global markets until Chinese trade issues have passed. But we also believe this risk is priced into markets.

Emerging market valuations are the lowest of the major regions. In many ways, their growth profiles and long-run opportunities are the most promising. We do not know the timing of whether the trade issues will be resolved in the first quarter, the second quarter or at all.

But our preferred emerging markets allocation combines long-run growth opportunities, exemplified by our ex-state-owned strategy, the [WisdomTree Emerging Markets ex-State-Owned Enterprises Fund \(XSOE\)](#), that overweights consumer, technology, and internet companies, and a multifactor strategy, the [WisdomTree Emerging Markets Multifactor Fund \(EMMF\)](#), that is more defensive. This emerging market strategy incorporates a currency-factor model that raises and lowers the beta profile dynamically, based on currency momentum signals.

This is a powerful combination for a potential to access the opportunity (valuations) with the short-term risks (a stronger dollar and more widespread volatility).

Unless otherwise stated, data source is Bloomberg, as of December 31, 2018.

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