Northern Trust | Katie Nixon: Lessons Learned from 3Q

For the first time since 2012, quarterly returns for global equities in US dollar terms were negative in the third quarter, with the All Country World Index losing over 9%. With the third quarter in history books now, it's worth taking a look back at a few key lessons learned from this tough quarter.

First, we observe that there can be too much of a good thing. Deep and broad weakness in commodity prices during the quarter drove the price of oil down 19% to new 2015 lows. Now there are more energy consumers than producers, so the impact on these lower prices should ultimately be a positive for disposable income and consumer spending.

However, we know that these impacts occur with a lag. The more immediate impact is on the producers-- energy companies as well as countries tied to the commodity complex-- and this shook investor confidence.

Second, a major driver of the volatility and negative returns of the third quarter was a growing concern around growth in China, exacerbated by the People's Bank of China's decision in mid-August to devalue their currency. Investors justifiably worried that the economic backdrop was potentially worse than reported.

Now there's a modest direct contribution that China makes to developed market economies. It's less than 5% of GDP. But lost in translation is that there are indirect consequences. China, with its heavy dependence on commodities, was the driver of growth in the emerging markets, which provided the fuel for global growth.

If China was truly growing more slowly than expected, this calls into question the ability of the emerging markets to continue their role as the world's growth tailwind.

And third, we were reminded that risk assets are volatile. With a seemingly endless largesse of global central banks potentially coming to an end with the first Fed rate hike in nine years, investors were cautious. Global central bank liquidity had worked its magic through the asset channel, having buoyed risk asset markets for several years. However, the impact to the real economy was more muted.

In the US, concern about the Fed handing the baton to an economy that was not quite ready for liftoff exacerbated investors' concerns about forward-looking returns, and if the Fed couldn't hand off the baton after six years of extraordinary ease, it called into question the efficacy of policies being implemented by the ECB and the Bank of Japan. When faced with uncertainty, investors vote with their feet, quickly.

So what does this mean for investors? As always during periods of heightened uncertainty, risk assets tend to correlate strongly. It doesn't matter much whether you were in US, European, or emerging market stocks during the third quarter, all were down for the period.

At the same time, let's look at the quarterly high-quality fixed income returns. Now both treasuries and high-quality corporates posted positive returns, highlighting the important benefits of the true and robust diversification associated with balancing risk assets with these risk control assets.

During periods of excessive volatility, we need to remind ourselves that assets serve a purpose. Risk assets are aligned against longer-term goals, and therefore we can wait out these inevitable periods of volatility as long as we have an appropriate reserve of risk control assets.