February 5, 2018

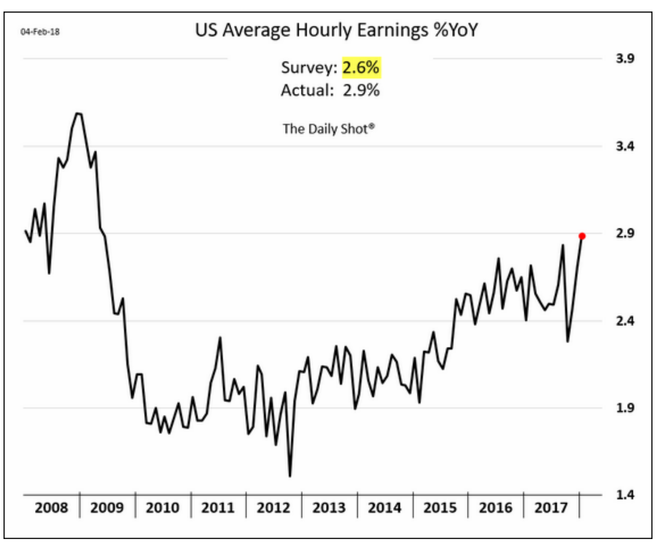
Volatility Returns in 2018

What Happened?

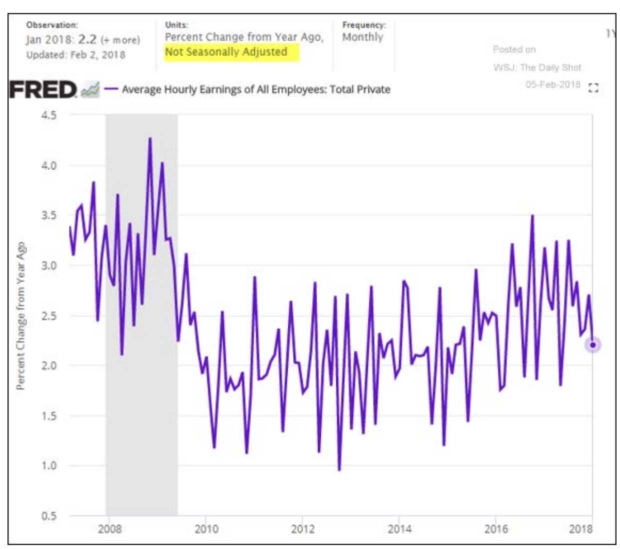
After the calmest year on record, volatility is suddenly back in the financial markets. On February 5th, the S&P 500 sank -4.1%, extending the previous Friday's selloff. With that, the market is down for the year. The day's decline accelerated just after 3 p.m., likely on algorithmic computer trading. The sudden drop was reminiscent of the May 2010 "flash crash," but was not as severe. The CBOE Volatility Index more than doubled to its highest level in 2 1/2 years, moving from 11 to 30.

Several factors contributed to the decline. First, the market's steep ascent the past several month simultaneously worried longer-term investors while drawing in many new investors. These investors are more likely to be "weak hands" (lacking conviction and likely to sell quickly). Too much, too fast meant that the market was due for a fall.

The main trigger was the Friday jobs report, which showed an above-expectations wage growth figure of 2.9% (see left-hand chart). While the trend toward rising wages is real and likely to strengthen, the selloff certainly seems excessive. Even Wall Street needs wages to rise to enable consumption, but it does need to be gradual. A single data point, especially one influenced strongly by a seasonal adjustment (see right-hand chart for non-seasonal adjusted data), is not a sign of out of control wage growth.



Source: Bureau of Labor Statistics via the Wall Street Journal

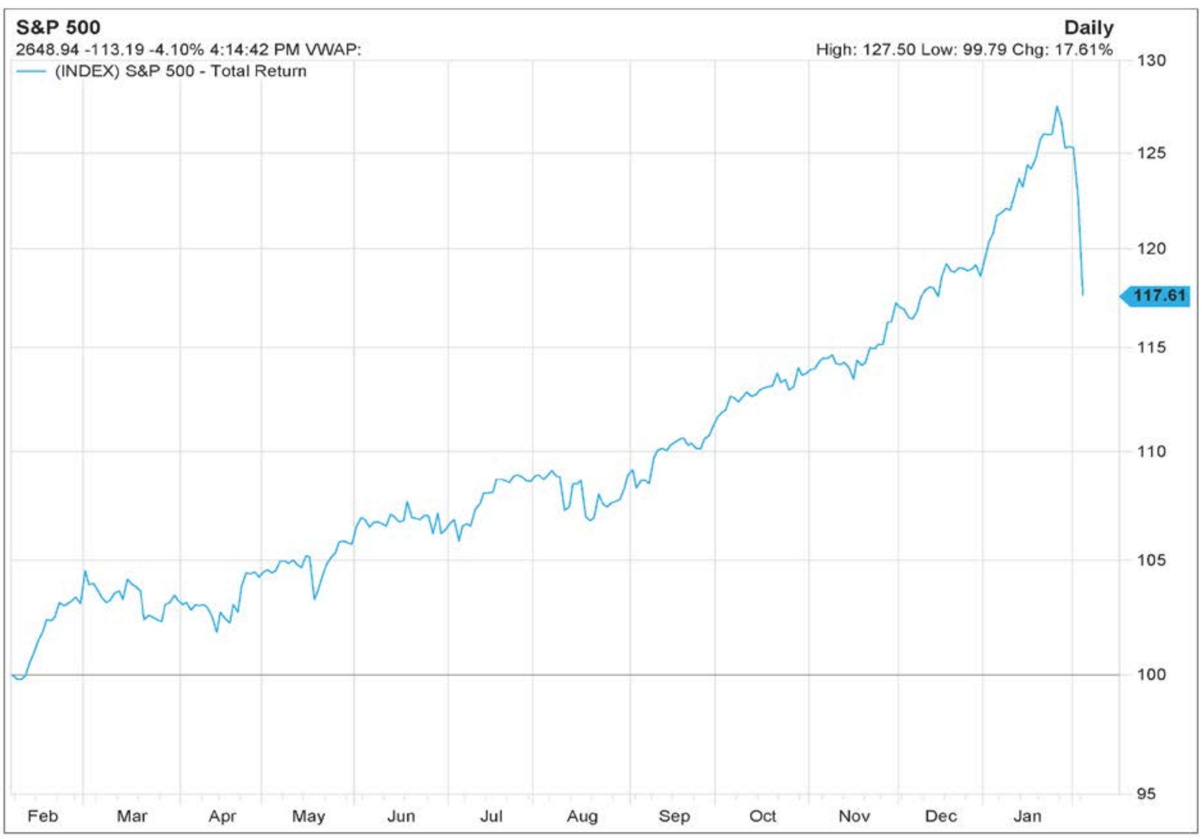


Source: St. Louis Federal Reserve Board

A few other factors also influenced the market. Related to the wage inflation concern, some investors fear new tax cuts will spur the economy to grow too quickly, resulting in a more aggressive Fed rate hike cycle. In addition, investors are more afraid that NAFTA talks will fall apart, which could also be disruptive. Finally, the large selloff in cryptocurrencies may also have bled over into regular financial markets.

What does this mean for investors?

For most investors, recent market movements shouldn't and don't mean much. Markets can be very calm, and they can be volatile – it just goes with the territory. If you have a long-term plan and are diversified, you are fine. Also, the stock market has been very, very good to investors as of late. For context, this is what a one-year total return chart of the S&P 500 index looks like:



That is to say, not too far off the highs and most likely, a needed correction.

The market's biggest concern is that stocks and bonds will fall *together* as rates rise in response to inflation. Yet, today Treasury bonds rallied (yields declined) while stocks fell, a classic risk-off response. We think bond yields are not rising too fast, just faster than the market previously expected. If this is happening because the economy is strong, but not overheating, the equity market will be fine. The evidence leads us to believe we are still a long way from an inflationary problem.

While we think the fundamental backdrop is still positive, we are committed to being disciplined. Strategically, this means maintaining diversification and uncorrelated investments. Tactically, this means listening to our asset allocation models. These models still indicate a positive environment for stocks and other growth oriented investments. If they deteriorate, we will recommend a move toward defense.

Please contact your wealth advisor with any questions or concerns.

Thank you,

Beman Capital Advisors