THE PRIVATE CLIENT GROUP
WEALTH MANAGEMENT

THE RETURN OF MARKET VOLATILITY

While a pullback can be unsettling, these types of drops are more typical than the recent period of sustained low volatility we have experienced.

Following a year of abnormally low volatility, stock market gyrations returned with a vengeance over the past week. Year-to-date gains in the S&P 500 index were wiped out by declines of 2.1% last Friday and 4.1% on Monday. After partially retracing losses on Tuesday, the downward slide resumed the next day and culminated in a 3.8% decline on Thursday. All told, the S&P 500 is down 8.6% for the month of February.

While a one week decline of 8.6% is certainly gut wrenching, it must be considered within the broader context of previous market gains. January's gain of 5.7% established 2018 as the strongest annual start for U.S. stocks since 1989 - nearly 30 years. Factoring in this gain, a year-to-date pullback of 3.3% through the close on February 8 seems far less consequential - certainly not catastrophic.

Continuing with the historical theme, the S&P 500's closing level of 2,581 was last seen on November 20th of last year. We have retraced the gains from only the past 80 days! Yet again, this is hardly a disaster and definitely not unusual. On that day in November, the S&P 500 was up 15.3% for 2017. In retrospect, how many investors would have been pleased to close out the year at that level and simply trade flat into February? Probably most, and that is precisely what has effectively transpired.

Historical returns acknowledged, how unusual is it for the S&P 500 to decline 8.6% over a one week period? As it turns out, not that unusual. On average, over the past 30 years, we have experienced such a decline about once every four years. Perhaps the fact we have not seen such a decline in over eight years makes the occurrence more shocking to us. We were overdue.

Armed with context and perspective, we can delve into the factors causing the market to struggle, our views going forward, and how investors should handle the return of more normal market volatility.

The first issue of concern is interest rates. Last week the 10-year Treasury Note's yield rose to its highest level in over four years. Interest rates are a critical ingredient to the pricing of assets. Lower interest rates enhance today's value of future cash flows. That is a major reason we have experienced phenomenal investment gains over the past nine years. Of course, the opposite is also true. Bond coupons, rental payments, corporate dividends and the like are all worth less today in a higher interest rate environment. That being fact, rising interest rates, or even the fear of higher rates, will negatively weigh on asset prices as they have over the past week.

The second and very much related issue unnerving investors is inflation. Wage inflation in the January employment report (released last Friday) hit 2.9% - the highest since the expansion began in the summer of 2009. Importantly, economists believe wage pressure of 3% or more begins to impact the aggregate level of inflation across the economy. Inflation erodes the purchasing power of money over time and - here is the kicker - feeds directly into interest rates (see the previous paragraph). Higher inflation and interest rates are a one two punch to the gut of the bull market.

Inflation and interest rates are very much impacted by 1) the level of economic activity and 2) central bank monetary policy. What we see at present is a modest acceleration in economic activity, but nothing along the lines of an overheating economy. Likewise, while still expansionary, the Federal Reserve is reining in loose monetary policies. Provided they maintain a reasonable path, there is reason to believe they could both hold inflation in check and usher in modestly higher interest rates at a measured pace. Circling back to the modest acceleration of economic growth, dramatic stock market declines outside of recessions are quite rare. *The fact the economy is improving is perhaps the best sign the previous week's stock market carnage is likely to be contained.*

Finally, what should investors do in light of greater uncertainty and a resumption of a more violent ride? First, try to ignore the onslaught of media chatter geared not to help you, but to sell advertising. Second, avoid the urge to take action. We are biologically wired to respond to perceived threats. After all, fight or flight worked well for our ancestors. Unfortunately, our primitive brains betray us when it comes to navigating investment markets and managing wealth. Nothing has transpired in recent days to require a response, nothing. As a matter of fact, responding during periods of market turbulence is most commonly done out of emotion. Managing portfolios through emotion is one of the most efficient ways to destroy wealth, and that is *clearly* not the goal.

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