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MARKET VOLATILITY UPDATE

FEBRUARY 6, 2018

Stock price volatility made a sudden increase to the upside in recent market sessions. The CBOE Volatility Index shot-up quickly, and now resides nearly 100% higher from the close of January 29. Coincidently, stock market volatility (uncertainty) goes hand-and-hand with falling stock market prices. Volatility is propelled further by stock market orders known as stop-loss orders. When initial stock market prices fall, stop-loss orders are eventually triggered, which further perpetuates the sell-off and volatility.

What triggered the sell-off in the first place? Well, a host of items are at the helm of speculation. One of the sounder theories is the future uncertainty of key central bank policy. The US economy, specifically, has a tight labor market; high consumer, investor, and business confidence indicators; and a political establishment ready to enlarge deficits for additional economic growth. Bundle all these factors together, and a new narrative of an overutilized economy emerges.

When an economy becomes overutilized, prices that households and businesses pay naturally bid up. Should prices rise high enough, one of the Federal Reserve's (Fed) mandates is at jeopardy, that is price predictability. The Fed manages price levels by interest rate policy. Interest rate policy now gets a bit more difficult for the Fed. The Fed recently commented on future inflation as a potential economic risk, so they are preparing to act. Act too fast-and the Fed could invert the yield curve, a potent predictor of future recessions. Act too slow-and inflationary risks could creep out into longer time horizons. Ultimately, expectations about future interest rate policy and inflation get priced into bond interest rates.

This Fed dilemma is not only unique to the US. Similar macro-risks currently underpin some other global economies and central banks. Naturally, asset-prices, such as stocks, are partially priced-off government yields. Since, government yields have risen in recent trading sessions, expectations about stocks must also change. This is called "price discovery" and is a natural process when global macroeconomic conditions begin to shift.

In light of these events, we feel it is appropriate to share some things to help you remain convicted in your investment plan and maintain an appropriate perspective.

1 With the Dow Jones Industrial Index falling over 1,000 points in a single day, perspective is key. As markets have consistently and aggressively climbed over the years, the law of large numbers takes shape. When the Dow plunged a record 22.6% on Oct. 19, 1987, it was a drop of 508 points because the average was so much lower at that time. Whereas the recent 1,175 point drop was approximately 4.6%.

2 Another piece of encouragement is the strength of sales and earnings strength in the economy. So far, about 50% of the US stock market has reported fourth-quarter results. Nearly 80% reporting, beat revenue estimates. GAAP earnings were down in the fourth-quarter only because of one-time tax credit write-offs related to the new tax law. More importantly, public managers are raising their 2018 revenues and earnings guidance citing benefits that are expected to accrue from the new tax law. A stock market meltdown when corporate profits are expected to rise further would be a paradox.

3 Stock market volatility is a normal phenomenon, and please realize, the year of 2017 was not a normal year of stock market volatility. To add some color here, the S&P 500 had zero trading days of price changes plus or minus 2% in all of 2017. In contrast, there were nine such days in 2016. If history has anything to say about today's volatility spike, it is that volatility will revert back to some average after buyers and sellers of stocks comes back into balance. If stocks don't have volatility, that means stocks are not behaving as they should. No investment has high expected returns and low expected risk. Market forces would not allow that to persist. Therefore, stocks need to behave as they normally do, with higher risk and higher return (relative to other assets).

4 Market and economic data is a foundational input to our investment research process. This causes some investors to believe that any large market move will surely impact our overall investment posture. However, with ultra-short-term volatility, we often find that no substantive data has fundamentally changed. Rather, this type of volatility is behaviorally driven. The Investment Team is diligently watching your account(s), but we don't let market jolts like the one being discussed here direct our decisions.

5 We emphasize the use of uncorrelated assets in our portfolios. That is why you never find our portfolios holding concentrated positions. Therefore, in an instance like this, holding many asset classes of little-to-moderate correlation acts as a self-control mechanism on downside risk. Diversified return sources are an essential part of future return compounding success. Something we take extremely seriously with the goal of improving the success rate of your financial plan.

6 Speculation around whether this is the end of the bull market or not, is not productive. Your overall investment allocation and risk tolerance should not be reactive to market conditions. We often discuss risk from two distinct perspectives. Fist, your ability to take risk which is a capacity discussion around your goals and objectives, and second your willingness to take risk which involves your emotions and behavior. Our disciplined planning process is based on your specific characteristics; this results in your overall investment mix. Again, this is independent of the level of stock market volatility at any given point in time. There have been many times where conventional wisdom (and pundits) may have fostered a belief about an ensuing correction due to a steep short-term market decline that ultimately never happened. We cannot let market direct your risk tolerance. It is critical to make sure you are not taking more risk than you are comfortable with. However, it is also important to ensure short term volatility does not sway you from a disciplined portfolio design that matches your long-term planning objectives.

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