Market Volatility and Viewpoints

Following a torrid January, equity markets reversed sharply in early February. The S&P 500 is now down 7.8% from its January 26st peak (as of market close on February 5th), and while this currently falls short of a market "correction" (normally defined as a drop of 10% or more), the severity of several one-day losses has generated fear among many investors and garnered significant media attention. For these reasons, we think it wise to communicate our observations to our clients and friends of the firm.

Background

Two key drivers of the stock market boom have been extremely low interest rates and low inflation. In fact, over much of the post Great Recession recovery, the US Federal Reserve (the Fed) has been at pains to assure inflation was at least positive and has used substantial firepower in the form of lowered interest rates and quantitative easing (QE) to do so. To date, these policies appear to have worked to raise the prices on risk assets and generally support the economy. However, the final judgment on the wisdom of pursuing such policies will be determined at a future date when the full impact of unwinding such polices can be observed over a full market cycle. The process of reversing interest rate cuts started in 2016 as the Fed began to work off the large ($4.5 trillion) bond holdings it amassed under its three QE programs in late 2017. These policy reversals have been mild to this point and the Fed has been extremely careful not to disrupt capital markets and the overall economy with sudden shifts.

Entering 2017, investors found the global economy in a near "goldilocks" state with economic expansion suggested by leading economic indicators across the globe. This was coupled with low inflation and low interest rates. In addition, the US economy stood to benefit from substantial fiscal stimulus in the form of tax reform and the possibility of material infrastructure spending. US employment was above the level normally referred to as "full employment" and the primary concern of the Fed was that favorable economic growth had not yet translated into rising wages for workers. The primary concern for professional investors was the lack of market volatility—suggesting investor complacency. Overall, the outlook was quite favorable for sustained economic growth *and remains so*.

However, it is also true that on January 1st bond yields remained low and were expected to rise—leading to headwinds for bond investors. Perhaps more concerning, US equity prices (measured by price-earnings ratios) were a full standard deviation above normal. While this was not true for foreign stocks (in either developed or emerging economies), many investors worried that stocks were overpriced in the US and were concerned that we may be headed for another cathartic market swoon such as occurred in 2001 with the so-called "Dot Com Bust" or in 2007 (the beginning of the great financial crisis—one primarily generated by housing prices).

WHAT HAPPENED?

Beginning with the January 29th trading sessions, equity markets began to retract along with bonds, gold and energy prices. In other words, most everything fell at once—providing a harrowing reminder of the beginnings of the 2007 financial crisis. The trigger appears to be a renewed concern for rising inflation that may lead the Fed to increase rates faster than otherwise expected. This belief, in turn, was spawned by an above-trend reading on wage inflation. Downturns in equity markets appeared to accelerate late in the day yesterday, which many believe is attributable to algorithmic trading programs that automatically cut risk exposures under certain circumstances. Volatility metrics also spiked up from historically low levels.

WHAT DO WE THINK?

First, let us observe that the proximate cause for renewed inflation concerns—rising wages—is a healthy and expected outcome in an expansion. In fact, the lack of wage gains in this recovery despite very low unemployment has vexed central bankers for the past several years. While we now have a single reading of increased wage inflation, this must be a welcome development in many quarters.

Second, though capital market movements have been very abrupt, they are logical and, taken as a whole, represent an incremental step toward normalcy. Interest rates may have risen quickly to reprice the possibility of higher growth and inflation but they *remain low* and accurately reflect the outlook for low but steady growth. As we noted in our recent Guide to the Markets the US treasury yield curve flattened over the past year, which is an unhealthy characteristic—an inverted yield curve is a precursor to recession. This phenomenon has been rapidly corrected in 2018.

Third, as we have also observed, concerns over US equity pricing are at least somewhat overblown. It is certainly true that in comparison to historical valuation metrics (e.g., P/E or CAPE ratios), US stocks are expensive. However, these measures take no account of the general level of interest rates, which should matter. After all, interest rates form the basis for the discount rate used to develop the net present value of stock earnings—low rates lead to higher valuations. In fact, a comparison of earnings yields (price/earnings) to bonds yields reveals that stocks entered the year at normal pricing levels. In other words, stocks were expensive if the analysis ignores interest rates, and normally priced if rates are considered.

Fourth, we welcome the return of volatility. The stock market pull-back experienced over the past few days may have seemed extreme but the drawdown has not even reached the level normally called a "correction". In a more normal environment, such an event would be viewed as more commonplace. The fact that this event is greeted as such an anomalous event is more a reflection of the abnormally low volatility that preceded it than a proper reflection of an unusual threat. Many things have been mispriced during the post-crisis recover and risk is one of them. For capital markets to function well, pricing must reflect risk and we welcome this development.

WHAT ARE WE DOING?

The time to enact measures to protect investors from adverse market swings is before the event—not during it. At that time, the cost of protection is at a premium and it is often too late to act in a productive manner. In fact, it is well known that individual investors tend to make significant, consequential behavioral mistakes (e.g., reflexively "go to cash") at times like these and we believe that one of our key roles is to help our clients avoid making such mistakes while under our care. Our approach is proactive and focuses on effective portfolio design. We do not rely on timely and clairvoyant tactical reactions to immediate market events—something we do not believe can be accomplished sustainably, no matter the level of resources applied to the task. Below we list several features of our approach and recent results:

- Macroeconomic protections. As our investors should know, we embed portfolio protections for both inflationary and deflationary scenarios into our portfolio designs—*always*. Those clients who are taking (or expected to take) distributions from their portfolios receive added protection.

- Hedging. When equity pricing becomes extended, we add to hedged-equity investments to protect portfolios from a downturn while continuing to participate. These strategies have performed as expected during the past week to protect capital.

- Bond Alternatives. Cedar Rowe deploys capital to alternative investment strategies that feature risk-return characteristics similar to the historical characteristics of bonds. These strategies perform a role similar to that of bonds but with more attractive performance qualities in a rising rate environment. These investments, too, performed better than bonds over the past week as they have for the past several years.

SUMMARY

The sudden and severe market movements of recent days have been unsettling to many investors, and the financial media, as usual, have done their part to heighten concern. We acknowledge that concern but recognize that capital markets are dynamic and that the path to sustained long-term growth is never straight. We also appreciate that US stocks are considered expensive by some metrics but note that they remain fairly priced by others, particularly when taking into account the strength of underlying fundamentals. For example, we note that 81% of companies that thus far have reported Fourth Quarter 2017 results have exceeded analyst expectations for revenue growth—a level of outperformance that represents the highest “beat rate” since 2008. Clearly, the overall economic story remains positive and intact. Increased pressure on wages is an attribute of a strong and growing economy, and inflation and counteractive increases in interest rates are customary by-products of an improved wage picture. What we’ve seen in the increased market volatility of recent days is likewise a normal and customary part of economic growth.

As always, we welcome your thoughts and comments.

Disclosures

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