PROSPECTS FOR VOLATILITY IN 2018

Overview

The fact that there is increased focus on volatility this year comes as no surprise. In 2017, the equity markets experienced the lowest volatility levels in 90 years — a scenario that is hardly sustainable.¹

A common measure of stock market volatility is the Chicago Board Options Exchange (CBOE) Volatility Index, referred to by its ticker symbol VIX. This index tracks expectations of future price fluctuation (called “implied volatility”) in the S&P 500 Index option over the next 12 months. High VIX values indicate high expected volatility, while low values correspond to expectations for stable share prices.

In early February, amid fears of rising inflation, the Dow Jones Industrial Average (DJIA) experienced its biggest one-day drop (4.6 percent) since 2011. At that point, the VIX index rose by more than double, to 37.²

Trade Disruptor

After regaining more than half of those February losses, the markets roiled again in early March on news of a potential global trade war. President Trump announced that the U.S. would begin imposing a global-wide 25 percent tariff on imported steel and a 10 percent tariff on imported aluminum. When the tariffs were first announced — followed by the resignation of the White House chief economic advisor, Gary Cohn, in opposition to higher tariffs — the event set off a multiday stock market slump:³

- DJIA dropped 420.22 points (1.7%)
- S&P 500 SPX dropped 36.16 points (1.3%)
- Nasdaq Composite Index COMP dropped 92 points (1.3%)

One week later, Trump signed a formal executive order to implement the tariffs in 15 days. At that time, Canada and Mexico were excluded pending a successful NAFTA treaty renegotiation.

Many economists believe that imposing higher tariffs could lead to serious damage in large sectors of the economy. A tariff, which is essentially a tax on imported goods from other countries, is designed to discourage sales to the U.S. in order to give domestic manufacturers a more competitive edge. Unfortunately, a smaller supply of U.S. materials and/or higher-priced imported materials generally leads to higher prices passed on to consumers.

¹ Smith & Williamson. March 2018. “Market volatility is a classic mid-cycle tantrum.”
⁴ Smith & Williamson. March 2018. “Market volatility is a classic mid-cycle tantrum.”

http://squaredawayblog.bc.edu/squared-away/stock-market-jitters-millennials-relax/.

The accompanying table demonstrates how quickly and dramatically the stock market tends to react to incendiary news events. However, check out the last column — which indicates the relatively swift and often impressive recovery that is hardly sustainable.¹
This, in turn, is likely to spur higher inflation. That, in turn, will lead the Fed to increase interest rates to make it more expensive to borrow money. Ultimately, higher borrowing costs discourage business investment and expansion, which can change the dynamics of the investment markets — sparking higher volatility.

Frequently enough, the mere hint or speculation of any of these events is enough to trigger market volatility — even before the events happen.

It also is worth noting that when one country imposes higher tariffs, other countries tend to retaliate with tariffs on goods exported from the U.S. When domestic manufacturers must pay more to export goods overseas, the cost is often offset — again — by higher prices to consumers. This rapid-fire chain of events is what is referred to as a trade war and, often enough, consumers are the ones who suffer the most from higher inflation.

Another point worth noting is that Trump has always been a proponent of higher taxes on imports. Therefore, his announcement did not come as a complete surprise. However, what may continue to rattle the markets is the high amount of the steel tariff and ongoing uncertainty over who will replace the top White House economic advisor.

**Market Resilience**

Despite this “man-made” threat, there are reasons to be optimistic about market stability this year. For starters, the economy has maintained its mid-cycle position and does not appear to be on the brink of another bear market. In fact, thanks to recent tax legislation and the potential for expansion in many industries, the prospects for domestic growth remain positive. Second, the recent price volatility experienced in the equity markets has not managed to infect the credit markets.

And finally, at the moment, inflation appears to remain subdued relative to the plethora of growth factors at play. As long as inflation runs below or around 2 percent, the Fed is expected to maintain its course of raising interest rates slowly and incrementally — which is good news for investment markets.⁴

“During the 2008-2009 stock market rout, boomers on the cusp of retiring called their financial advisers in a panic. ... Many investors pulled out. ... It took more than five years, but the market did recover, and the boomers who sat tight have gotten their money back — and more.”⁵
Historical Perspective

The accompanying table demonstrates how quickly and dramatically the stock market tends to react to incendiary news events. However, check out the last column — which indicates the relatively swift and often impressive recovery rate within a year.\(^6\)

<table>
<thead>
<tr>
<th>Event</th>
<th>Reaction Dates</th>
<th>DJIA Gain/Loss</th>
<th>DJIA change 12 months later</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929 Market Crash</td>
<td>Oct 11 - Nov 13, 1929</td>
<td>- 43.7</td>
<td>11.8</td>
</tr>
<tr>
<td>Germany invades France</td>
<td>May 9 - June 22, 1940</td>
<td>- 17.1</td>
<td>- 5.2</td>
</tr>
<tr>
<td>Pearl Harbor</td>
<td>Dec 6 - 10, 1941</td>
<td>- 12.0</td>
<td>26.3</td>
</tr>
<tr>
<td>Korean War</td>
<td>June 23 - July 13, 1950</td>
<td>- 6.5</td>
<td>5.4</td>
</tr>
<tr>
<td>JFK assassinated</td>
<td>Nov 21 - 22, 1963</td>
<td>- 2.9</td>
<td>24.0</td>
</tr>
<tr>
<td>US bombs Cambodia</td>
<td>April 29 - May 14, 1970</td>
<td>- 7.1</td>
<td>36.7</td>
</tr>
<tr>
<td>Nixon resigns</td>
<td>Aug 7 - Aug 29, 1974</td>
<td>- 17.6</td>
<td>27.2</td>
</tr>
<tr>
<td>1987 financial panic</td>
<td>Oct 2 - 19, 1987</td>
<td>- 34.2</td>
<td>24.2</td>
</tr>
<tr>
<td>Iraq invades Kuwait</td>
<td>Aug 2 - 23, 1990</td>
<td>- 13.3</td>
<td>22.4</td>
</tr>
<tr>
<td>9-11 terrorist attacks</td>
<td>Sep 11 - 21, 2001</td>
<td>- 14.3</td>
<td>- 6.7</td>
</tr>
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<td>Lehman Brothers collapse</td>
<td>Sep 15 - 16, 2008</td>
<td>1.3</td>
<td>- 11.5</td>
</tr>
<tr>
<td>Chinese market turmoil</td>
<td>Aug 21 - 25, 2015</td>
<td>- 4.8</td>
<td>17.8</td>
</tr>
<tr>
<td>Brexit</td>
<td>June 23 - 27, 2017</td>
<td>- 4.8</td>
<td>25.2</td>
</tr>
</tbody>
</table>

It’s worth reiterating that market volatility is not always a bad thing. It can sometimes work as a catalyst to reset overvalued stocks and provide room for subsequent growth. Resilient investors who choose to stay the course during volatile times are frequently rewarded with outperformance over the long term.

Final Thoughts

If there is one thing the investment markets do not like, it’s uncertainty. If there’s one trait that predominantly characterizes the Trump administration, it’s uncertainty. The key thing to remember is that while day-to-day market fluctuations can be influenced by headlines, rumors and investor sentiment, long-term performance is generally driven by fundamentals. From a fundamental perspective, economic growth and the number of companies meeting or surpassing their quarterly expectations remain positive.

The lesson here is to expect volatility to continue throughout 2018, but work with your financial advisor to determine if the underlying reasons are superficial or have the potential to change long-term fundamentals. Even then, consider your personal circumstances and financial goals before making any alterations to your portfolio.
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