MID-CONTINENT CAPITAL

CONSILIUM*

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*advice; judgment; resolution; wisdom

Not All Volatility Is Created Equal

The S&P 500 Index finally ended its remarkable run of gains, finishing the first quarter of 2018 with a total return of -0.76%. Despite Brexit, turmoil around the US presidential election and its aftermath, and a very unpredictable policy environment, the stock market had managed to generate positive results every quarter since September 2015. Indeed, the external environment for equity investing was far more volatile than the equity markets themselves – a development that almost no one would have seen coming had they been able to predict the actual, momentous events (both good and bad) of the last two years.

The modest drop in the first quarter obscures the wild ride investors endured. After shooting higher by 7.4% by January 26, the equity market tumbled by as much as 11.8% (at its lowest level) over the ensuing two weeks, then rallied 10.3% in the next two weeks, and finally slumped 7.9% in the last two weeks of March. This was by far the most challenging period for equity investors in two years.

Market volatility itself is volatile. We have lived through periods marked by weak returns and low volatility, and vice versa. While it is extremely difficult to accurately predict the course of the equity markets, it is even harder to predict volatility. The period of persistently declining volatility starting in 2012 therefore stands out by historic standards, capped by results in 2017 when the S&P 500 rose or fell by 1% or more just eight times. In 2018, the market had matched that result in just the first six weeks of trading – and as this is being written, moves of more than 1% had occurred in nine of the last 12 trading sessions.

When the markets' behavior changes significantly, we naturally want to know why, and whether our approach to investing should adjust accordingly. But sometimes, there is less going on than meets the eye, and we believe that such is the case in early 2018. Consider the litany of "explanations" offered in the business media since early February:

- Wage inflation is set to surge, finally reflecting strong employment; much higher interest rates are coming. ***(Following an upward blip in January, subsequent data looks much less alarming.***)

- Tariffs will lead to trade wars. ***(Trump's narrowly focused, and subsequently refined, gift to the steel and aluminum industries was met with an even more finely targeted response from China, even as talks continue. Events thus far look nothing like a trade "war".)***

- Washington regulators are going to dismantle Facebook, Google and Amazon, our engines of high-tech growth. ***(In such situations, it is worth remembering that 90% of what politicians say is mere grandstanding that never leads to meaningful legislation.)***

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- Interest rates haven't been able to rise above 3% and are now falling – the economy is as good as it can get and can only deteriorate from here. ***(Yes, there were commentators who argued, when the equity market first touched its recent lows on February 9, that it was because the economy was too "hot". Then, when the market revisited those lows at the end of March, it was because the economy was set to falter.)***

If prevailing wisdom changes this frequently, it is very likely that all the rationalizations being served up are wrong, and that nothing more than human emotion is at work. The economic backdrop is nearly identical to what prevailed for much of 2017, with the added benefit of tax cuts now flowing through to consumers and businesses.

Violent market corrections can happen for almost any reason, at any time, and they are nearly impossible to avoid other than via sheer luck. We can think of such episodes as "volatility you can ignore". What we want to sidestep is the much rarer correction that threatens to become a bear market, owing mainly to an economic downturn – "volatility you must respect". We believe it is not nearly as difficult to spot such circumstances, and we see little to fear at the moment – but as always, we will remain vigilant and open to all outcomes.

The early months of 2018 appears to be one of those moments when paying too much attention to daily price fluctuation drains mental capital and leaves investors (professional and otherwise) ill-equipped to make good decisions. We suggest tuning out the "noise" while the more irritable and cantankerous investors among us cleanse themselves of their premature pessimism.

Sources: Bloomberg, FactSet, Marketwatch