Comments on Recent Market Volatility 1/3/2019

By: Gary Quinzel, Vice President, Chief Investment Officer

To Our Clients and Readers,

We would not say that this recent equity pullback is not a "big deal," and not to worry. However, the markets always go through cycles, and we will try to put this in perspective.

- We have enjoyed 10 years since the last major pullback, with the previous low set back in March 2009.
- The prior high was November 2007;
  - By March 2009, the market fell 57%;
  - April 2010, 11 months after the lows, the markets recovered 75% of the loss;
  - March 2013, the markets had recovered all the loss and started new highs.
- There were pullbacks of between 15% and 20% five times over the next 8 years;
  - Each of these pullbacks launched the market higher than the start of the pullback.

The Nasdaq Composite Index is now in "Bear Market" territory, having dropped by 20% from its peak this Fall. However, taken in context, the tech-heavy index was only down -3.8% in 2018, and is still up over 32% over the past three years. Even though the stock market ended the year in negative territory, overall the market cap of the S&P 500 has still gained over $15 trillion since 2009. Entering the New Year, the S&P 500 is selling at 14.4X "top down" consensus forward earnings per share, with a growing dividend yield of 2.2%. This valuation appears cheap given low real (after inflation) interest rates, and compared to the 20-year average P/E of 16.3

Solid Fundamentals Underlie the Volatile Market Conditions

The markets are currently focused more on fear than economic fundamentals. We are very aware of these cycles, and what is driving the markets. The current themes of trade war uncertainty, slowing growth, geopolitical fears, the government shutdown, and rising interest rates, are trumping the economic reality. On top of these conditions, hedge funds have had large redemptions, forcing them to sell into the downturn. As of December 27th, the 'fear and greed index' level is at an 8 (out of 100), meaning investors are "extremely fearful" of current market conditions.

While most of the events above have caused negative emotions, GDP is still growing, unemployment is at multi-decade lows, consumers are spending, financial institutions are much stronger than they were in 2007, and in general the corporate sector is still healthy and has cash on hand. Selling out of a market already down 20% would be giving into the fear and following the crowd down a potentially dangerous road.

Volatility is Back, How Do You Handle It?

Volatility is not a recent phenomenon, but it was easy to forget about volatility in 2017. Each year, one can expect the market to experience a significant correction, which for the S&P 500 has averaged approximately 14% since 1980. To compare, the volatility index for the S&P 500 is at 29.96 as of December 27th. Although past performance is no guarantee of future results, history has shown that those who chose to stay the course were rewarded for their patience more often than not. Remember, we moved 2 steps forward in 2017, and 1 ½ back in 2018, but we're still ahead of the game.

We have warned of the return of volatility since the middle of 2017, and as we look forward to 2019 we predict that there will be more to come. With slowing economic growth, rising interest rates, and recession risks rising, all these factors indicate more market uncertainty ahead. We believe that lower volatility, higher quality, and value-oriented investments will provide the best investment opportunities in the coming months. And of course, investment discipline is paramount. Staying invested in a strategic allocation aligned with ones' long-term objectives and risk tolerance will provide the best opportunity for success.

A recent Washington Post article quoted Francis Kinniry of the Vanguard Investment Strategy Group, saying **"The right asset allocation is balancing regret that you do not have more in equities when the market is doing well with remorse when you have too much in the equities when the market is going down. It is a balancing act."** With bonds finally providing meaningful yield and stocks looking fairly priced, a balanced portfolio hasn't looked this good in some time.

Be on the lookout for our January Investment Commentary which will include updates on international markets and other potential sources of volatility in 2019.

Happy New Year and Best Wishes in 2019!

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