MARKET COMMENTARY:
Recent Market Volatility
February 7, 2018

Global equity markets started off 2018 on a very strong pace, with all major global equity benchmarks posting very robust returns during the month of January. In the United States, all three major equity benchmarks (Dow Jones, S&P 500 and Nasdaq) posted returns above 5.5%. For perspective, the S&P 500 Index gained 21.8% for all of 2017, so in just one month in 2018, U.S. equities captured a quarter of their gains from the prior year. That is a remarkable pace that would have been very difficult to sustain through the rest of the year. Volatility levels were also at or near record lows and 2017 was an unusually calm year for the markets.

Things changed quickly at the start of February. On Friday, February 2nd, the Dow Jones Industrial Average (DJIA) plunged 666 points. Investors were hopeful that the weekend would allow cooler heads to prevail, but the downward momentum continued. On Monday, February 5th:

- The Dow Jones declined 1,175 points, its biggest one day point decline in history. At one point, the Dow was down 1,500 points before recovering slightly. In percentage terms, Monday's loss of -4.6%, did not even rank in the top 25 in history.
- The S&P 500 index fell more than 4% to 2,649. This was the index's largest single day decline since August 2011 when it fell 4.5%. This erased the year-to-date gains for 2018, and the index fell by 7.8% from its recent high of 2,873, reached on January 26th. The index had gone 404 trading days since its last 5% drawdown, the longest stretch of time in nearly 90 years! Since 1929, pullbacks of 5% have occurred every 92 days on average.[1] Based on history, the S&P 500 Index was overdue for a pullback.

On Tuesday, February 6th, the roller coaster ride continued. The Dow opened lower by another 600 points, but managed to recover all of those losses and actually finish in positive territory by the closing bell, rising 567 points, or 2.3%. This represented an intraday swing of over 1,100 points.

While it is hard to pin this volatility on any specific event, there are several possible explanations for the market's wild swings over the last several days.

- Inflation – Last Friday's jobs report showed that average U.S. wages grew at the fastest pace in eight years, raising concerns over higher inflation. A sudden spike in inflation could cause the Federal Reserve to increase interest rates faster than originally anticipated, putting an end to the easy monetary policy that has supported the market rally over the last several years.
- Bond market yields – Interest rates have been on the rise since the start of the year. The US Treasury 10-year yield started 2018 at 2.40% and reached 2.84% by February 2nd, the highest level in four years. While this increase was not particularly unusual, it was a steep move in the span of one month. For perspective, the 10-year yield rose only 42 bps in 2017 from its lowest point during the year, and that was over the course of nearly 4 months, from beginning of September to December. The January rise is likely due to investors reassessing their outlook on economic growth and prospects for higher inflation.
- Stock market valuations – Equity valuations have been rising throughout this bull market. Some measures, like the Shiller Cyclically Adjusted P/E Ratio (commonly called the CAPE) are at the levels last seen before the tech bubble in the late 1990s. So while corporate earnings have been rising, rising stock prices may be going through an adjustment phase to more adequately reflect earnings expectations.

It is worth repeating that market gyrations do not necessarily reflect economic fundamentals as economic changes occur at a much slower pace. Fundamentally, from an economic and business perspective, nothing appears to have changed over the last week. The labor market appears strong, corporations have been reporting very strong profits and the government passed the most significant pro-business tax cut in the last 30 years. Although the U.S. economy appears to be in the latter stages of its economic cycle, current indicators do not suggest that a recession is around the corner.

[1] Goldman Sachs Portfolio Strategy Research, "US Macroscope: Look past the technical correction, focus on the fundamentals", February 6, 2018.

This type of market volatility is surely unnerving for investors, particularly after a period when markets did not exhibit much volatility at all. While it is hard to predict where equity markets will go from here, it is important to keep in mind that stocks are a risky investment and these type of events are expected from time to time. In other words, market drawdowns are not uncommon and are viewed as part of a healthily functioning financial market.

As always, we continue to urge investors to take a long-term perspective when these type of events occur and to not overreact in response to short-term market swings. Investors should review their objectives, goals, risk profiles and their investment time horizons before making any significant portfolio changes. SageView will continue to monitor this market volatility and provide updates as necessary. If you have questions or need additional information, please do not hesitate to contact us.

‘