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MARKETCOMMENTARY

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Volatility Up as Concerns Rise Despite Strong GDP Growth

By Daniel Wildermuth

> *Today, investors face a conundrum of seemingly conflicting data. The economy is stronger than it's ever been during the long running expansion.*

As we move further into the second half of the year, the market is subjecting investors to larger swings amid greater uncertainty regarding various economic drivers. Against this backdrop, the last two calendars years' uninterrupted market gains more clearly stand out as the anomaly that they were.

The last full week of July provided a great example of heightened investor nervousness. Facebook and Twitter, two of the giants in social media, announced downward revisions of future earnings, kicking off unusually large losses. Twitter's (TWTR) stock fell over 20% in a day, and Facebook (FB) lost 19% of its value, wiping off $119 billion from its total market capitalization and recording the biggest single day individual company value drop in U.S. history. Partly because of their losses, the S&P 500 was down 1% in two trading days, although it was still up a bit for the week.

The losses of Facebook and Twitter also provide additional insight when viewed against their 2018 performance. Before the week's carnage, Facebook and Twitter shares had risen 23% and 79%, respectively, since the beginning of the year.

In fact, on the year, only six stocks representing about 15% of the S&P 500–Facebook, Amazon, Apple, Microsoft, Google (Google's C shares) and Alphabet (Google's A shares)–have generated nearly all the market gains. The top-heavy performance driven by these companies presents a significant concentration risk to investors. As an example, the technology-heavy Nasdaq index has outperformed the broader S&P 500 index about 3 to 1 on the year, but last week, the Nasdaq was down 1.1%, while the S&P 500 climbed 0.6%.

In the recent market run-up, the performance of these few companies has benefitted passive investors, since passive strategies blindingly follow the indexes. However, the process can quickly reverse. By contrast, active managers normally perform better when there's breadth in the market. In down markets, passive strategies tend struggle as ETFs sell disproportionate amounts of their largest holdings. Simply, passive investments generally provide low cost exposure to market risk, not lower risk.

Technology exposure and risk can also come from odd sources. Europe's new privacy law that went into effect in May is partly to blame for Facebook's and Twitter's challenges. As a consumer, if you have logged onto a website recently and had to accept the site's use of cookies you have seen the far-reaching impact of the European regulations, and the new regulations are much more pervasive than simply approval of cookies. Many companies have seen their marketing lists reduced by over 90% because of the new rules, and many websites have simply gone dark in European markets because of compliance challenges. While business will adjust to the new regulations, consequences remain uncertain.

The last week of July was volatile despite exceptional reports regarding U.S. economic growth which propelled the broader market forward. Strong consumer spending, robust business spending, rising exports, and even government spending drove U.S. GDP growth up at an annualized rate of 4.1% for the quarter, its highest level in four years. Growth was even better at 4.3% when less dependable categories such as trade, inventories and government spending were removed. The numbers seem to suggest that the U.S.'s second longest expansion will just keep going.

Yet, the increasing volatility of

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markets and individual company share prices seems to reveal more consternation about current markets and economic conditions. Potential Trade Wars rightly worry investors. The recent rise in tariffs impacting numerous global economies represents the first shift toward restricted trade in over 50 years, which could profoundly impact the economy through increasing costs and presenting new and unexpected obstacles.

Unemployment has also reached unprecedentedly low levels. While this is great for consumer spending and anyone looking for a job, a lack of personnel available to companies trying to fill positions tends to cause other problems. Companies may not be able to grow or expand as quickly, and investors worry that the increases in recent earnings may slow or even end.

Residential real estate is also sending warning signs with the market suffering from rising interest rates and prices that reached an all-time record in June according to the National Association of Realtors. The average interest rate on a 30-year mortgage has risen more than half a percentage point since early January to 4.54%, according to Freddie Mac. Existing home sales dropped in June for the third straight month while new home purchases hit their slowest pace in eight months. Annual price gains in May were also their slowest in almost a year and a half.

Some fear that a weakening housing market may be a preview of future problems for corporate America. Just like consumers, higher borrowing costs for companies results in less money available elsewhere, which for companies, directly impacts earnings. Much has also been made about the yield-curve nearing inversion, meaning that short term interest rates are almost higher than long-term rates. Historically, an inverted yield-curve has correlated strongly with a coming recession. However, it's important to note that this is correlation, not causation, and today's circumstances are highly unique as we are exiting a period of record low rates.

Today, investors face a conundrum of seemingly conflicting data. The economy is stronger than it's ever been during the long running expansion. Wages are growing, corporate taxes are lower, unemployment is at record low, corporate profits recently logged record highs, business spending is up, and a myriad of other indicators signal ongoing economic strength. At the same time, headwinds include rising rates, lack of human capital, new tariffs, potentially much larger Trade Wars, European regulations and fairly rich equity valuations.

The result appears to be that despite many positive reports from numerous economic indicators, much skepticism of the market remains and is likely driving increased volatility. A continuation of the market's wonderfully steady upward march of 2016 and 2017 seems highly unlikely. Yet, enough good news remains to potentially keep the market lurching upward for the foreseeable future. More simply, today's equity market seems more normal – anything can happen.

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