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Interpreting Market Volatility

As the market does what we would expect investors should keep emotions in check.

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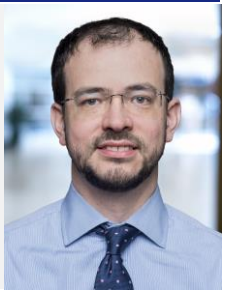

October 10th saw the Dow plunge more than 3% – a relatively steep decline – and the S&P 500 suffered similar losses. The NASDAQ was down 4% by day's end. The emotional impact of this sell-off was probably amplified by the fact that as recently as the week before, the Dow was flirting with all-time highs. Not coincidentally, that's one of the conditions that have historically preceded market pullbacks.

Human nature and the dynamics of crowd behavior can turn investor enthusiasm into panic very quickly. But, if we take a breath – as the market seems to be doing after a long uphill run – and look at the bigger picture, the recent pullback makes sense. The risks highlighted in our 2018 outlook remain very much on the table. In addition to high stock valuations, we have a Federal Reserve with untested leadership at a time when inflationary concerns are pushing interest rates higher. Expectations for economic growth and stock market earnings have been relatively high for much of the year. Even if these factors weren't in play, history would tell us to expect increased volatility as mid-term elections draw nearer.

To be sure there are some unexpected factors at play as well. The trade war between the United States and China has introduced another degree of uncertainty for businesses and investors around the world.

Since the mid-year, the weight of the evidence approach we take to market and economic analysis has argued for caution, and that assessment stands. But it's important to note that some of the factors putting pressure on stock prices today have encouraging longer-term implications.

Part of the Fed's commitment to raising rates is based on the strength of the economy, which seems to be on a sustainable upward track thanks in part to higher median household wages. More people are finally participating in the economic recovery that's been a work in progress since 2009, and more dollars in consumers' hands could help shift economic growth into a higher gear.

The seasonal angst that historically accompanies elections in the United States typically resolves itself soon after the outcomes of those contests are known. And while past performance is no guarantee of future results, history (and holiday shopping season) could argue that stocks should end the year on an upswing.

In the meantime, keep in mind that news outlets have a job to do. They want your attention and will shout over each other to get it. But when it comes to the market, the dynamics are more nuanced than a headline can explain. Rather than react to headlines, you should tune out the noise and look at your investments dispassionately. Recent market momentum and the lack of volatility we saw in 2017 could easily have carried individual investors outside of their comfort zones. Now is the time to gut check your risk tolerance, recalibrate your short-term expectations and work with your Baird Financial Advisor to make sure your investment strategy is appropriately aligned with your financial goals and time horizon.