Volatility Returns to the Markets

2018 saw volatility return to the markets … and it made for a wild ride. Investors who had gotten comfortable in the low-volatility environment of the previous nine years felt it most acutely. We experienced the single greatest point drop in history at the end of January! The fourth quarter was the third worst quarter since WWII! December was the worst month since WWII! The good news is that the S&P 500 was only down 4.4% by the end of the year despite those milestones.

VOLATILITY IS THE NEW NORMAL

What changed last year to bring volatility back to the markets? Certainly, we can look to macroeconomic factors in ongoing trade talks with China, recession fears, political uncertainty, energy supplies relative to demand, acts of God, and the ever-present threat of military conflicts. In response to each of these, we can adjust our asset allocation to minimize the impact to our risk assets (equities for most of us).

There is a bigger picture, though, that goes beyond asset allocation strategies. We should be concerned with how our money is invested within asset classes. The relatively quiet markets of the last decade made passive investing (matching market indices) look better than active management (through professional money managers). The tide is changing.

Since the Fiscal Crisis, the Fed has kept interest rates near zero and has also been the greatest buyer of government debt. This combination fueled liquidity in the economy. This environment was purposeful to keep calm in the financial markets. The environment is different now.

The Fed Funds rate is nearly 3% and they have been trying to reduce their balance sheet—being the greatest buyer of government debt in the world ballooned their balance sheet from its traditional level of about $750 billion to nearly $5 trillion! Although they are pausing their recent strategy of interest rate hikes and balance sheet reductions, the environment going forward won't be so calm for unmanaged market indices.

FORECASTING A SLOWDOWN

Markets tend to move based on trends, not absolutes. The trend leading into 2018 was for robust economic growth going forward. That changed as economic forecasts changed. While 2018 posted an annual GDP growth number of 3%, 2019's GDP growth is forecast to be around 2.7%. Worse still, the forecast in future years is expected to return to levels below 2% per year. Even though economists are not forecasting a recession, the changing trend can drive changes in the markets.

UNDERSTANDING MARKET MOVEMENT

As investors, it's important to understand what drives markets. In the short-term, they tend to react emotionally as investors think about "greed and fear." Greed drives short-term gains as investors try to take advantage of market growth and fear drives markets down as investors try to avoid losses. Another way to describe this is "momentum." Market volatility is a swinging pendulum where rising markets build fear of the next sell-off and falling markets build anticipation of the next rally. Trying to time these reversions has proven to not be consistently effective.

Over the long-term, markets tend to move based on the fundamentals of the economy. In a growing economy, we expect markets and values to also grow. Given the economic forecasts for GDP growth, dividends, and inflation, investors should plan for asset growth rates in the single digits for the foreseeable future.

HANDLING VOLATILITY

One simple truth in investing is that what worked well over the most recent timeframe tends to lag when markets change. The last 10 years saw the rise of index investing as most money managers were not able to beat their benchmark indices. A great deal of money went to "passive" index investments.

An index is a basket of companies considered to be representative of a segment of the market. The members of the basket don't have to have a strong financial position or any other qualifying measure. Over time, the member companies tend to change as industries evolve. Companies may go bankrupt or merge with stronger rivals.

The low-interest rate environment of the last decade essentially provided "cheap money" to companies requiring financing to maintain operations. The availability of cash at very favorable rates has a way of masking weak financials. Businesses that would otherwise fail or consolidate have instead been kept afloat. This made it possible for unmanaged indices to consistently beat money managers who are selective in their investment choices.

As debts come due, volatility in the indices will return as businesses with weak financial positions have to refinance at higher interest rates. Just as real estate markets go from buyers' markets to sellers' markets the financial markets go from "darts thrown at random investment options" to "careful security selection."

We are in a money manager's environment now and I recommend caution with the indices going forward. Seek professional advice and favor a high credit quality investment approach.

Patrick Yanke is a Raleigh-based financial advisor. Opinions expressed here are mine and not necessarily those of RJFS. The information is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation. Investing involves risk and you may incur a profit or loss regardless of strategy selected. The S&P 500 is an unmanaged index of 500 widely held stocks. It is not possible to invest directly in an index. Asset allocation and diversification do not guarantee a profit not protect against a loss. www.yankefinancial.com.