

Absence (of market volatility) made the heart grow fonder

By Colin Moore, Global Chief Investment Officer

- *Investors loved financial markets while market volatility was noticeably absent. But now it's back.*
- *Investors are fearful that inflation will rise faster than expected due to the impact of a weak dollar on import prices and rising wages, and that as a result interest rates may also rise faster than expected. But the reemergence of wage growth may be a positive for economic growth and corporate earnings.*
- *We see any further decline in equity prices as an opportunity to be a selective buyer of risk assets in multi-asset portfolios.*
- *Volatility may be back, and it is reminding us we didn't really like it that much, but the reality is it's part of investing. In short, remain invested, and don't let behavioral investing take its toll.*

Low volatility has been a feature of the US equity market for several years. The absence of significant volatility and the surge in the S&P 500 Index drove investor sentiment to very high levels in 2017. Last year the S&P 500 Index was up almost 20%, yet January marked the fastest start for the index ever. Equity market indices reached our target for the entire year of 2018 before January even ended. This arguably set the stage for an overdue correction, which is what we have seen.

I like to think of market corrections in terms of good, bad or ugly. Ugly corrections occur when there are deteriorating fundamentals in corporate earnings or economic growth, and stretched technical factors (such as momentum and valuation). A good correction occurs when only the technical factors are stretched but the fundamentals are solid or improving. This is the case with this week's market movements. Momentum and valuations are high, but we have rising corporate earnings and improving consumer sentiment. Releasing some of the exuberance is healthy for the market. Predicting exactly where the market will correct to is difficult, but generally I assume if the S&P 500 Index falls 5%, it has a reasonable chance of falling 8%–12%.

This recent market correction is a good reminder to focus on investment horizons and investment goals. Jeff Knight, Head of the Global Investment Solutions team, provided a good anecdote to remind us the importance of keeping a long-term perspective: At the end of 2007, Warren Buffet made a bet that the S&P 500 Index would outperform an assortment of pooled hedge fund investments over a ten-year period¹. He got off to a bad start because the index declined almost 50% the year after he made the bet. But when the bet was complete 10 years later, he won it. The S&P 500 Index had rebounded after its loss and went on to experience one of the longest bull markets ever.

Why is this happening?

Investors are fearful that inflation (another item that has been absent for a long time) will rise faster than expected due to the impact of a weak dollar on import prices and rising wages, and that as a result interest

¹ Page 20, Berkshire Hathaway 2016 letter to shareholders.

rates may also rise faster than expected. We have been reporting for a while that interest rates have nowhere to go but up, but it is the rate of that increase that makes investors nervous.

In early February, a new jobs report was released showing that wage data had increased 2.9% year over year², which is the highest we've seen in recent years. So far, the Fed has patiently waited to raise rates because they wanted to see stronger inflation and employment data. This February jobs report made people uneasy, wondering if this could be the sign the Fed was looking for to increase the speed of interest rate increases. Remember the rule of '3-3-3': Some investors speculate that if GDP growth reaches 3%, the yield on 10-year Treasury reaches 3% and wage inflation reaches 3%, it may prove to the Fed that economic growth is real, and it can raise rates faster than the market had expected.

This isn't necessarily a negative thing. One of the biggest issues limiting US economic growth, which is dependent on consumer spending growth, has been the absence of wage growth. Depending on the pace, the reemergence of wage growth may be a positive for economic growth and corporate earnings. Investors haven't had to deal with these nuances for some time, hence the recent years of low volatility. We can't be certain how this renewed uncertainty will be resolved, but we know uncertainty itself roils markets.

What kind of strategies are driving market volatility?

Systematic low volatility strategies compound the market's reaction. When we look at the types of market participants who were selling their investments, they weren't institutional or professional investors. Most of the selling came from systematic strategies that were triggered by a small uptick in volatility. These strategies' target level of volatility is measured by the VIX Index³, and when volatility recently doubled (from very low levels), the strategies were forced to automatically sell S&P futures and buy bond futures. Although this isn't a large part of the market, it amplified the market's reaction to the recent small uptick in volatility.

Does this change our forecast for market growth?

No. The underlying fundamentals of the stocks and bonds we invest in are strong, and we don't expect a recession this year. This was a healthy sell-off and our upside equity market targets for the year remain intact. We still see strong global synchronized growth, and our forecast for US GDP growth remains near 3%. Although our five-year return forecast across asset classes is below historical average, we still expect positive returns. I believe the current market volatility was driven by a fear of rates rising faster than expected, rather than any fundamental change in our growth forecast.

What should investors expect?

We see any further decline in equity prices as an opportunity to be a selective buyer of risk assets in multi-asset portfolios. The global asset allocation team is currently overweight emerging markets, commodities and alternative investments. As active equity managers who conduct fundamental research on the securities we invest in, we'll continue to buy both U.S. and global stocks if their prices drop to our price

² Employment Situation Summary, Bureau of Labor Statistics, 2/2/2018.

³ The Chicago Board Options Exchange Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities of S&P 500 Index options.

targets and their fundamentals are strong. Active managers and flexible, diversified strategies can tactically position investors for this opportunity.

Summary box

I tend to repeat myself with this suggestion, but don't panic. Our work suggests the behavior trait of selling out of products with high volatility (or selling low and buying high) is costing people around 200 basis points (2%) per year. Volatility may be back, and it is reminding us we didn't really like it that much, but the reality is it's part of investing. Talk to your advisor and make sure your asset allocation is consistent with your risk tolerances and goals. In short, remain invested, and don't let behavioral investing take its toll.

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