

## Three Questions Investors Need Answered Now: *Volatility, It Really Does Exist!*



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**Col. Nathan R. Jessup:** I'll answer the question.

You want answers?

**Lt. Daniel Kaffee:** I think I'm entitled!

**Jessup:** You want answers?!

**Kaffee:** I want the truth!

**Jessup:** You can't *handle* the truth!

— *A Few Good Men*, 1992 film

What do the Abominable Snowman, Loch Ness Monster, Bigfoot and capital market volatility have in common? Up until recently, they were all believed to be folktales. Mythical creatures that lurked on the fringe, never too far but never really present either. Impossible to prove or disprove. However, when volatility reared its ugly head in early February's good old fashioned stock market correction, it forced investors to confront a number of prospective threats to the long bull market — rising inflation, surging bond yields and contractionary monetary policies.

Now, like the determined Lt. Daniel Kaffee in *A Few Good Men*, investors find themselves desperately searching for the whole truth.

Let's face it, though. Deep down, in places that investors "don't like to talk about at parties," investors may fear the answers to today's most pressing market questions:

1. Is there a Powell Put?
2. Has the Goldilocks Era ended?
3. Is this an overdue correction or the beginning of the end?

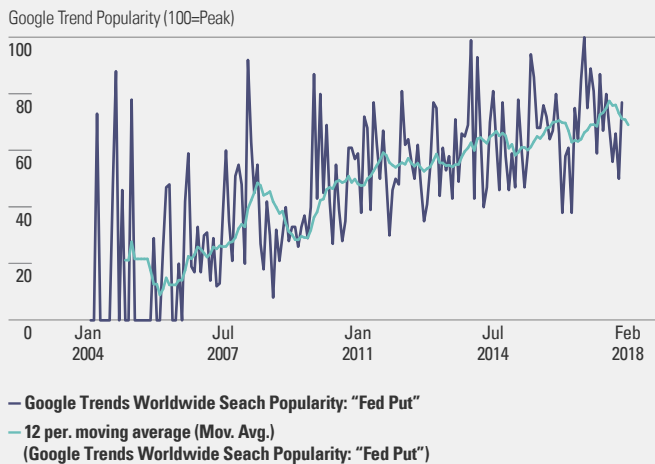
All this market uncertainty is Kryptonite for investors, triggering innate behavioral biases that can harm portfolios. That is, investors tend to leap before they look, overreacting to new or changing information in the short term. And that can result in financial assets getting mispriced. Importantly, however, investors' mood swings and short-term asset price anomalies can create exciting and potentially profitable opportunities. Of course, to leap with courage and conviction to pursue these opportunities, investors must overcome the current dreaded uncertainty by getting clarity on those three essential questions.

### #1. Yes, Virginia, There Is a Powell Put

Investors have long been comforted by the warmth of the Fed Put. It all started about 30 years ago with then Federal Reserve Chairman Alan Greenspan's response to the 1987 stock market crash. The Fed Put has been dutifully carried out by every Fed chairman since that fateful time, handed down from one chairman to the next like a mantle of investor protection. The term "put" refers to a put option, a contractual obligation giving its holder the right to sell an asset at a particular price to a counterparty. The put option can be exercised if asset prices decline below that put price, protecting the holder from further losses.

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**Figure 1: Investors have Been Increasingly Aware of the Concept of the ‘Fed Put’ During this Bull Market**



Source: Google Trends, February 20, 2018.

Throughout the last 30 years, every time the stock market has delivered devastating losses to investors, the Fed has lowered the Fed Funds rate, injecting liquidity into the markets to encourage risk-taking and avoid further disaster. Taking a walk down Financial Catastrophe Lane, in addition to 1987, the Fed has exercised its theoretical put option during the savings and loan crisis, Gulf War, Mexican peso crisis, Asian financial crisis, Long Term Capital Management (LTCM) crisis, Y2K, the technology, media and telecom (TMT) bubble bursting, 9/11 and repeatedly from the early stages of the global financial crisis to the present.

Investors have learned that in times of market stress over the past 30 years, they can usually rely on the Fed Put as their security blanket.

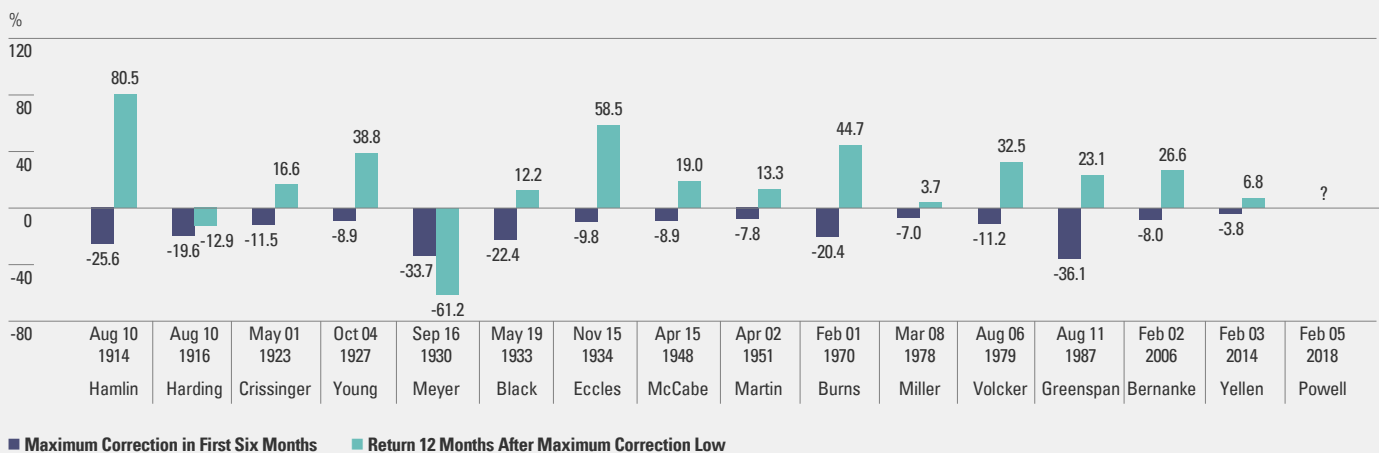
Not surprisingly, this perception has caused higher asset valuations, narrower credit spreads and measures of financial volatility near historic lows. But at some point does the dependency have to end? Ever try to wean a child from their security blanket? I have. It’s not pretty. We used to call my son’s “Twirly.” We even had a travel version – “Travel Twirly” – for family vacations. It was a long, hard-fought battle to finally wrestle that “Twirly” from him.

Every time there is a change in leadership at the Fed, investor anxiety increases that they will be weaned from their security blanket – the Fed Put. And, either purposefully or coincidentally, the new Fed chairman is always tested in the first 12 months on the job. The market, like a petulant child, resists the removal of its security blanket and throws a tantrum. And, so far, over the last three decades, the Fed has responded by coddling investors to sooth their anxiety.

Jerome Powell was sworn in as the new US Federal Reserve Chairman on February 5, and on cue, the very same week, the stock market suffered its first 10 percent correction in nearly 500 trading days, ending one of the most docile periods in modern stock market history.<sup>1</sup> Investors don’t know yet if they can count on a Powell Put and that uncertainty has contributed to the market’s recent bout of volatility.

The Fed faces a Catch-22. Change monetary policy too quickly and risk stalling growth when it finally seems to be gaining some traction. Or keep the monetary policy faucets on full blast and risk inflating another financial asset bubble. How does that end? Fear not, brave investor.

**Figure 2: Corrections Are Not Uncommon at the Start of a New Fed Chair’s Tenure, Though the Rebound is Usually Robust**



Source: LPL Research, FactSet as of February 6, 2018.

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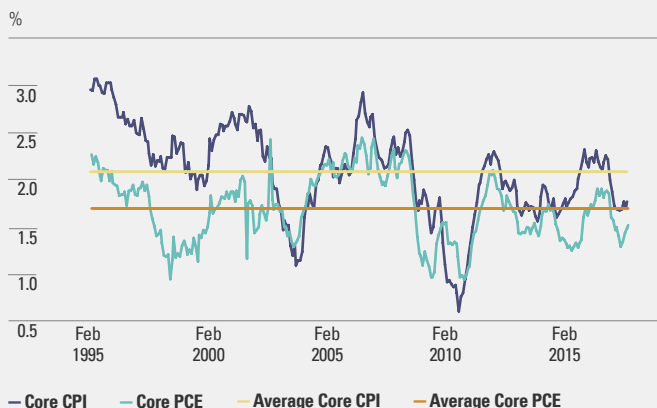
When faced with this dilemma the Fed will always err on the side of excessive risk-taking versus mistakenly putting the US economy into a recession. How can I be so sure? I have 30 years of evidence and countless calamities to support my opinion.

## #2. Baby Bear: “Someone’s Been Sleeping in My Bed...and She’s Still There!”

Rapidly rising interest rates and increasing inflation measures have investors concerned that the Goldilocks economy, characterized by modest growth, low rates and benign inflation, may be ending. This not too hot, not too cold climate has kept the Fed in an easing mood, the economy out of recession and, of course, a bear market at bay. More broadly, interest rates and inflation have been trending lower for three decades, something investors have been warned couldn’t last forever.

So could the recent rise in interest rates and inflation finally signal a pivot to a new trend? Identifying this potential change in trend is critical for investors for two reasons. First, the value of any financial asset (i.e., stocks, bonds and real estate) is simply the present value of its future cash flows discounted at the discount rate. The higher the discount rate, the lower the present value of the asset. Increasing interest rates and inflation put upward pressure on the discount rate. If investors conclude that the discount rate is rising, they may determine that financial assets, already at lofty valuations, need to be revalued to much lower levels. In addition, if the multi-decade downward trend in rates and inflation is indeed reversing course, it could result in a more permanent reset of asset valuations.

**Figure 3: Despite Fears, Two Main Inflationary Measures Remain Below Average**



Source: Bloomberg Finance, L.P., February 20, 2018.

Second, the biggest risk to stocks may be the continued move higher in Treasury yields driven not by better growth prospects, but by an increase in the term premium over concerns about inflation and growing US deficits. This scenario increases the likelihood of a monetary policy mistake. The Fed may be forced to aggressively raise interest rates to address rapidly rising inflation. Without at least a commensurate pick-up in economic growth, the Fed risks prematurely ending the current synchronized global growth resurgence.

In early February, mounting uncertainty regarding Goldilocks’ future, the discount rate used to value financial assets and whether Treasury yields were rising due to better growth prospects or something worse were all major contributors to the increase in volatility and the stock market correction. Not to worry. Goldilocks is still comfortably sleeping in Baby Bear’s bed without much fear. The US economy grew at a still meager 2.3 percent in 2017. It may accelerate further in 2018 due to increasing fiscal stimulus, a healthy consumer, improving business investment and better global growth. But it’s still not likely to break through 3 percent for the calendar year. According to the Bureau of Economic Analysis, US GDP hasn’t breached the 3 percent threshold in a dozen calendar years, last achieving the feat in 2005.

And while it doesn’t take a rocket scientist to observe the meaningful increases in both interest rates and inflation so far in 2018, the levels of both measures still remain well below historical norms. The 10-year Treasury yield has been creeping toward 3 percent, reaching its highest point in four years, yet it remains 54 percent below its long-term average.<sup>2</sup> On February 14, consumer prices, measured by the consumer price index (CPI), rose much faster than many economists had been expecting. But, according to the *Financial Times*, even with the sharp rise in consumer prices this month, neither the core CPI (excluding food and energy) nor the personal consumption expenditure deflator, the Fed’s preferred measure of inflation, look all that remarkable. In fact, the *Financial Times* goes on to acknowledge that inflation remains closer to the bottom of its post-crisis range than to the top of it.<sup>3</sup> As for inflation, it’s picking up, but doing so very gradually. Soon, higher rates are likely to attract long-term investors such as pension plans and insurers, especially those interested in US corporate bonds, further supporting bond prices and keeping yields in check.

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Therefore, fears that the Goldilocks Era is ending are dramatically overblown. Improving global growth and a still relatively low level of inflation continues to support risk assets in the near term. In the aftermath of February's stock market correction, global equity markets already have begun to rebound while volatility has fallen. Investors are getting more comfortable with the idea that although inflation and rates are increasing, they are not going to lead to significantly tighter monetary conditions or threaten financial stability. Goldilocks lives!

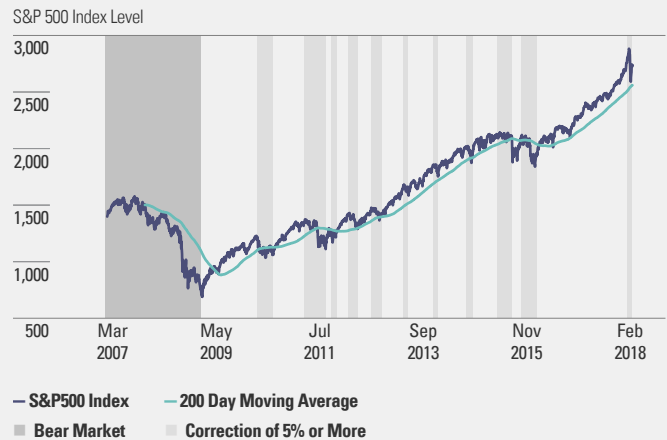
### #3. Inhale, Exhale: Relax, It's Still About the Fundamentals

Let me cut to the chase. This was a long overdue, good old fashioned, healthy stock market correction. The low volatility melt-up bridging December 2017 and January 2018 took the market to uncomfortable technical levels. E-mini S&P 500 futures indicated that traders and other market participants had become extremely long the stock market. This resulted in the 11th strongest January for the S&P 500 since 1950. According to Strategas Research Partners, the average full-year return for the previous top 10 starts to the year was about 22 percent.<sup>1</sup> If the old market adage of "As goes January, so goes the year" holds true, then 2018 might just be another solid year for investors. Yet, despite the euphoric sentiment last month, many of the typical signs of a bull market top were not present. Market leadership has remained cyclical, earnings and cash flows are likely to increase notably this year and credit spreads remain tight. In addition, fiscal and regulatory stimulus may have ushered in a real business cycle in which economic data and asset prices are more variable.

This correction is not a harbinger of a bear market. Many examples across global capital markets support that opinion. Emerging markets have held up quite well — a reaction that compares favorably to what happened in 2015–2016 when fears of a hard landing in China's economy pressured markets globally. Similarly, emerging markets debt spreads widened initially, but then quickly returned to January 2018 levels.<sup>5</sup> In high yield markets, there has been considerable selling, yet spreads are not gapping wider and remain tight by historical standards. The latest bout of selling did not set off the broad flight to quality that often accompanies a change in economic sentiment. Additionally, the volatility spike is more likely the result of the unwinding of short volatility positions than a sign that recession risk is increasing.

Inflationary pressures may be building, but it seems more accurate that long-term interest rates are increasing due to expectations of higher real GDP growth.

**Figure 4: Stock Market Pullbacks are Far from Uncommon**



Source: Bloomberg Finance, L.P., February 20, 2018.

This should be a positive for stocks until inflationary pressures force the Fed to tighten aggressively. With a real Fed Funds rate that is still negative, a lot of time might still remain in this bull market — although the days of multiple expansion are probably fading fast.

Finally, the 2003 tax cut may provide a helpful guide to the potential financial market implications of the recently passed tax reform. So far the response has been eerily similar — stocks increased, the dollar weakened, and gold and oil moved higher. But, perhaps, the most important change in 2003 was the 10-year Treasury yield surging as economic growth repriced higher. In 2003, equities suffered a six-week sell-off as yields climbed. Ultimately stocks moved higher by 15 percent over the next four months once the rapid rise in yields ended.<sup>6</sup> Today, we may be observing a similar surge in yields as growth again reprices higher. Could today's stock market performance follow a similar positive pattern when yields stop climbing?

### How to Handle the Truth and the Road Ahead

Early February's volatility reminds us that it has been a long time since most investors suffered much performance pain. Between solid asset price gains and the historically docile investment environment, investors may have forgotten what a correction feels like. As we look ahead, keep in mind that February's market correction was both long overdue and probably healthy for future returns. And investors' overreaction to modestly higher interest rates, rising inflation expectations and fears of contractionary monetary policies may have created some potentially profitable buying opportunities for longer-term investors.

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Consider, for example, that as a result of the recent correction, the rolling price-to-earnings (P/E) ratio on the S&P 500 Index has moved down from 18.39 times on January 26 through the two-year median of 17.18 times to sit now at 16.31 times, while the S&P 500 earnings yield has climbed from 5.18 percent to 5.77 percent.<sup>7</sup>

How should investors allocate capital to pursue new opportunities? In uncertain times, it's tempting to pause, even to look back and dwell on past choices, rather than evaluate and chart a future course. Despite recent volatility, I see white lines on that road ahead, drawn by sound long-term fundamentals, contained inflationary pressures and forever-cautious central bankers.

<sup>1</sup> Bloomberg Finance, L.P., February 6, 2018.

<sup>2</sup> Bloomberg Finance, L.P., February 20, 2018.

<sup>3</sup> Pan Kwan Yuk and Adam Samson, "US inflation rises more than expected in January," *Financial Times*. February 14, 2018.

<sup>4</sup> Strategas Research Partners, "Tantrum or Start of Secular Bear Market in Bonds? In Short-Term, Not Much Difference for Stocks," February 5, 2018.

<sup>5</sup> Lori Heinel, "Markets are Skittish, But Still No Bear," SSGA Blog. February 9, 2018.

<sup>6</sup> Strategas Research Partners, "Stocks Briefly Corrected in '03 as Yields Increased." February 5, 2018.

<sup>7</sup> Bloomberg Finance, L.P., February 9, 2018.

However, just as Lt. Kaffee carefully plots his clients' defense in *A Few Good Men*, it will be important to dig deep into the details in the days and months ahead. I'm confident that my insights above can help inform investors' decision-making and map the way forward. To recap: The Powell Put is alive and well. The Goldilocks Era is still just right. And, in early February, we witnessed a normal stock market correction, the first in nearly 500 days, not the beginning of the end.

### Glossary

**Consumer Price Index (CPI)** A widely used measure of inflation at the consumer level that helps evaluate changes in cost of living. The CPI is composed of a basket of consumer goods and services across the economy and is calculated by the US Department of Labor by assessing price changes in the basket of goods and services and averaging them.

**Earnings Yield** A valuation metric that uses the ratio of the company's earnings per share versus its current stock price. It is the inverse of the P/E ratio.

**Price-to-Earnings (P/E) Ratio** A valuation metric that uses the ratio of the company's current stock price versus its earnings per share.

**S&P® 500 Index** A market value weighted index of 500 stocks that reflects the performance of a large cap universe made up of companies selected by economists; the S&P 500 is one of the common benchmarks for the US stock market, and investment products based on the S&P 500 include index funds and exchange-traded funds.

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