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BEACON'S POINT: THE RETURN OF VOLATILITY

After a long absence, volatility has finally returned to the financial market's stage. On Monday, the Dow Jones Industrial Average dropped (intra-day) by 1,600 points. The index partially recovered to end the day down 1,175 points. News headlines highlighted this as the largest point decline in Dow history. However, in percentage terms, the 4.6% drop represents just the 108th largest in market history. The broader S&P 500 Index lost 4.1% on the day.

Given the magnitude and duration of the market advance since the 2008 financial crisis, it is important to keep daily index returns in perspective. 2017 was a very strong year for equities with the S&P 500 posting an almost 22% gain (including dividends). This is more than double the long-term average of 9.8% (measured over the last 90 years). After an outlier period, it is not unreasonable to expect some moderation in terms of performance.

Nevertheless, many investors likely saw Monday as a wake-up call. It followed a downward trend from the prior week. At the end of the day, the Dow was down 8.3% from its January 26th peak. The S&P 500 was down 7.5% over the same period. While these percentage declines are not very large compared to previous corrections, they did take many by surprise. Last year saw one of the least volatile equity markets on record. Prior to Monday, the S&P had gone 400 days without a 5% pullback.

Why did the sell-off occur?

Many believe that the trigger was inflation concerns. Wage growth has increased and hourly pay is 2.9% higher than last year while unemployment remains low. The Institute for Supply Management reported solid expansion in the manufacturing industry. Meanwhile, consumer confidence and spending remain high. In other words, the U.S. economy is strong and improving.

However, the recently-passed tax reform legislation has created some uncertainty around the exact impact that corporate tax savings and cash repatriation would have on GDP growth and inflation. In an environment of low unemployment and accelerating wage growth, businesses will eventually need to raise prices to meet payroll demands. This would create inflationary pressures and likely push the Federal Reserve to raise interest rates more aggressively. In turn, higher interest rates would increase business borrowing costs, thereby reducing corporate profits. Similarly, individuals would pay more for loans and decrease their consumption levels. Finally, bonds would become relatively more attractive, resulting in potentially lower investor demand for stocks.

Essentially, the narrative is that things are so good that the Federal Reserve will raise interest rates more quickly than currently expected and, consequently, the economy will slow down. This reasoning certainly has merit: given where we are in the business cycle, rising inflation and interest rates could very well turn out to be the cause of the next economic slowdown. However, despite several hikes over the last two years, U.S. interest rates are still at very low levels. Furthermore, the Federal Reserve has been consistently transparent in communicating the direction and timing of planned rate changes. For this reason, it is unlikely that the fear-of-aggressive-Fed-tightening scenario fully explains the recent drop in the stock market.

Technical factors may also have played a role. Just before 3:00PM EST on Monday, the Dow was down 600 points; twelve minutes later, it was down 1,597 points. This sudden plunge could be attributed to automated trading. Many large financial firms use computer programs to buy and sell securities according to specific algorithms and triggers. By some estimates, quantitative trading executed by computers accounts for more than half of all stock trades. The initial sell decision may have been made by humans who saw the 2.9% wage growth reading as an inflection point. Algorithmic trading likely accelerated the sell-off as that trigger was hit and stock market participants attempted to stop losses.

What does this mean going forward?

Only time will tell if this episode is just a blip on a continued march upward or the beginning of a correction. It is worth noting that both the Dow and the S&P indices were up on Tuesday; the Dow finished 567 points (2.3%) higher and the S&P gained 46.2 points (1.7%) on the day. More importantly, investors should keep in mind that market corrections are a natural and necessary part of investing. Recent exceptionally low volatility notwithstanding, downturns are expected to occur regularly, and are especially likely after a prolonged strong bull market and in an environment of elevated valuations. Long-term equity returns cannot be achieved without experiencing equity volatility. The calm markets of 2017 were an aberration, not the norm, and a return to more typical levels of volatility is, in fact, a sign of a healthy market.

How should investors respond?

It is easy to get caught up in the euphoria of a market that just keeps going up and take on more risk; it is even easier to get caught up in the fear of a sudden drop and sell at the wrong time. In addition, attempting to accurately and consistently time the market is close to impossible. Although short-term drawdowns, such as the recent sell-off, are emotionally challenging for investors, they are inevitable and necessary. We are confident that our approach to asset allocation and manager selection will continue to serve our clients well as we enter a new stage in the cycle, where market volatility may be more of a factor than it was in the recent past.

Beacon Pointe believes that every investor's circumstances are unique. As your advisor, we work with you at the start of the relationship to make sure that you choose an asset allocation appropriate for your situation. In order to do that, we discuss and understand your goals, timeframes, and level of risk tolerance. Once you are allocated appropriately, and unless your needs have changed, your most prudent response to market turmoil would usually be staying the course. Patience and discipline are key ingredients of successful long-term investing. If, on the other hand, your goals, time horizon, or level of risk tolerance have changed, then we encourage you to have a further discussion with your advisor.

Please feel free to call Beacon Pointe should you need additional information or have any questions.