MANAGED ASSET PORTFOLIOS

Volatility Snaps Back:
What a Difference a Week Makes

As recently as a week ago, the most frequent question investors asked sounded similar to: "How long can these good times last?" Today the polar opposite question is being explored; namely: "Is this the beginning of another 2008?"

First, let's begin with framing recent stock market activity in the proper context. The financial media is having a field day as they breathlessly report that the Dow Jones Industrial Average suffered the "Biggest one day decline in history; over 1,000 points!" While that is true, it is a bit misleading, as on a percentage basis, yesterday's decline does not even rank in the top 50. We understand that sharp market selloffs can be unsettling and downright painful. The fact that we have not had a major selloff since 2016 makes this decline feel particularly noteworthy. January actually marked the 10th consecutive month of gains for the S&P 500, the longest period of monthly advances in 59 years. Since the bull market began in March of 2009, there have been four corrections; this retreat is shaping up to be correction number five. Keep in mind, Wall Street typically defines corrections as declines of 10%+ and bear markets as declines of 20%+.

What changed?

Last Friday, the Labor Department reported a strong jobs number along with strong wage growth. As much as one would think this news would be viewed positively, Wall Street became alarmed that such data may force the Fed to raise interest rates more aggressively than previously thought. Additionally, the Fed has a new Chairman, Jerome Powell, who succeeded Janet Yellen on Monday. It is not untypical for Wall Street to "test" new Fed Chiefs. Alan Greenspan was tested with the crash in 1987 and Ben Bernanke was tested with the economic crisis of 2008- 2009. We suspect investors are now eagerly awaiting Chairman Powell's comments and will soon be attempting to read between the lines in search of clues for any shift in Fed Policy. We believe Chairman Powell's views will not be much different than his predecessor. Rates will likely have a modest upward bias, coming off a period of record low interest rates, from a better than 30 year bull market for bonds. Interestingly enough, recent stock market declines should actually serve to reduce the likelihood of rates being raised too aggressively. In fact, as of this morning, the market is now pricing in only 2 rate hikes rather than 3 or more last week.

We have been positioning our client's portfolios for higher rates for quite some time. We have kept the maturities on bond holdings short (on average, less than a year and a half and nothing past three years to maturity). We just do not see the benefit of owning longer dated bonds here….too much risk…not enough reward!

We view recent stock market declines in the context of a "correction" rather than the beginning of a "bear market." Generally, bear markets coincide with economic recessions. While our viewpoints on the economy are more tepid than others, we do not foresee a recession. In order for a recession to occur, the Fed would have to aggressively move rates higher and choke out the economic expansion. This would appear to be unlikely, as on February 2nd John Williams, president of the San Francisco Fed, said the Fed should stick to a plan for *gradual rate hikes*.

While we do not attempt to be market timers, we believe the decline will have a bit more to go on the downside, as some of the weaker hands are washed out. We attribute the swiftness of the decline to the growing popularity of ETFs and passive investing. Not traditional ones that mimic the S&P 500, or particular sectors, but the leveraged ones, that allow speculators to "bet" on volatility and other esoteric items. Some of these EFTs are leveraged 3x – 4x and magnify the opportunity of significant gains or losses. When extreme losses occur in these products, traders begin selling more liquid securities, regardless of their individual underlying fundamentals. Novartis is a perfect example. After a solid earnings report on January 24, the stock marched higher to a 52-week high on January 26th. Since then, the stock is off nearly 9%. The stock now pays a 3.5% dividend yield and sells at less than 16 times earnings. Our argument for additional short-term market weakness stems from the fact that there is an estimated $500 billion of assets tied to funds that target a given level of volatility-- two-thirds of which are traded by algorithms that look poised to reduce equity exposure of the heels of Monday's decline. This type of programmed trading becomes self-perpetuating. The more stocks go down, the more the computer driven algorithms sell, thereby exacerbating declines. Such selling is done regardless of the economy and underlying fundamentals. We will look to capitalize on this mindless robotic selling by adding to quality stocks that are needlessly being punished by the algorithmic trading. We believe an investment approach rooted in fundamentals supported by a strict value discipline is the best way to weather this current volatility.

In short, we do not believe the economic backdrop warrants a bear market type decline. As we addressed in the recent issue of MAP Views, there are certainly pockets of excessive speculation (e.g. cryptocurrencies). However, there are also select investment ideas that appear compelling. Once the market's jitters subside, we believe investors will once again embrace value investing. Value stocks tend to outperform during periods of economic expansion. As consumers spend more money, inflation typically increases and resultantly benefits the types of stocks we tend to own.

We further believe that there is a high probability of policy makers stepping in to calm the markets should continued market declines warrant such actions. Our portfolios will not be immune to the declines of the broader markets; however, rest assured, we will continue to work diligently in search of investments that offer our clients the best opportunity for long-term risk adjusted returns. Should you have further questions or concerns, we encourage you to contact your MAP Advisor.

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