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# Stay The Course

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The significant market volatility in early February has produced some of the largest price swings in history across the equity marketplace. The initial spark was a somewhat surprising increase in 10-year Treasury bond yields, which approached 2.9 percent, and concerns that rising inflation expectations could eventually force a tighter-than-expected interest rate policy by the Federal Reserve. The negative drawdown did not stop in the U.S. The severe declines and excessive price swings carried overseas this week.

In our view, given the almost 8-percent run up in equity prices in January to record levels, which followed a 20 percent gain in the U.S. and more than 30 percent in Emerging Markets for the full year 2017, stock markets were vulnerable to a quick and visible change in the most widely followed trends, namely low inflation, low volatility, and low yields around the world. In other words, capital markets were vulnerable to a re-pricing of risk—a re-application of capital based on the relationship between risk and reward, in our view. Combine the reversal of long-standing trends with over-exposure by global investors to areas such as low volatility, higher-yielding, and longer-duration investments and the increasing inter-connectedness of quantitative trading or machine-driven programs, and you have a strong catalyst for a significant re-positioning of portfolios over a very short period of time. This then creates a negative feedback loop that could produce even higher volatility and potentially a large-scale shift toward risk aversion. In our opinion, this is what we have experienced so far in February and similar events over the course of history.

In the current case, we believe equities were overdue for pull-backs. Pull-backs that can be greater than 5 percent, or in some cases, have resulted in a 10 percent correction, which could also be more volatile than expected. In fact, this is not un-common. On average, since 1930, we have experienced around three declines of 5 percent or more and a 10 percent decline or more on an annual basis. The response to the historical downdrafts have varied. However, when the fundamentals of the economy, profits, and broader financial conditions remained attractive and were not affected by a recession or financial system deterioration, the markets eventually recovered. We believe this correction is more technical in nature and driven by fears of higher interest rates and concerns about tighter interest rate policy, which rattled complacency that had built up in the markets in the past year. In our view, this complacency was evident during the full year 2017 when volatility stayed at or close to record low levels. In 2017 alone, the S&P 500 never experienced a 2 percent move either up or down (as measured by the Chicago Board Options Exchange VIX index), which is abnormal given this has happened, on average, eight times per year over the last three decades.

Moreover, we do not see deterioration in balance sheets or the credit markets; nor do we see signs of financial system leverage building up across the capital market system at this time. Shorter-term, more speculative allocators appear to be paying more attention to technical factors as they determine when and where to deploy capital. From our perspective, equity markets are trying to find a bottom based on certain average price levels that have tended to attract investors back into risk assets. We believe this is a process that could take time, potentially weeks or months—not necessarily days.

As we noted earlier, it's a process that involves the re-positioning of the relationship between risk and reward, in our view. The good news is that given our positive thoughts on global economic growth and corporate profits and our belief that financial conditions still remain attractive— particularly since real rates around the world are still low—we expect equity markets to stabilize in the near term. We believe this could then establish a new base that potentially allows the investment fundamentals to pull through and resume the long-term secular bull market trend. The combination of the prospects for solid corporate earnings mixed with the potential for better-than-expected global growth overall could re-ignite demand for equity assets over time.

We believe long-term investors should stay the course. Don't over-react to daily volatility; have a diversified investment strategy plan that aligns to your long term goals; and take advantage of market weakness over time by rebalancing portfolios when asset class exposures drift too far away from strategic allocations. It is our view that market opportunities present themselves at points in time, while long-term wealth is built over time. Stay the course, and be active with your investment strategies.



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