# Episode 4: "Bulls, Bears and Volatility"

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Newsclip: Breaking news… the Dow closing down more than 500 points today, a second day in a row of triple digit losses, wiping out most of the gains the Dow has made this year… (*News clip from 11/11/2018*).

Candace: The stock market doesn't always make things easy. There are periods when its ups-and-downs can be truly unnerving. Just this past winter, the Dow plunged more than 1,000 points in one day, its largest one-day point decline ever.

Newsclip: U.S. stocks almost into freefall, as the Dow suffers its worst single day point fall, some eleven hundred and seventy-nine points. (*News clip from 02/05/2018*).

Candace The next day, it zoomed back up, 567 points. Then, two days later, it dropped over 1,000 points again. In fact, by mid-October, we'd seen five of the biggest one-day point gains ever, and eight of the biggest one-day point losses ever.

That kind of wild swinging is what's known as market volatility and that's what we're going to be talking about today. We're going to take a long view, seeing how volatility has played out in the past and we're going to look at the kinds of things that can cause markets to become unsettled, and what steps, if any, you should take while it's happening and what it means for the economy and for your investments.

We'll also unpack the real meaning of bull and bear markets and provide some important historical context to help you make better sense of both types of markets.

You're listening to the Merrill Lynch Perspectives Podcast. I'm Candace Browning, head of BofA Merrill Lynch Global Research, and with me is Michael Hartnett, chief investment strategist for BofA Merrill Lynch Global Research.

Michael: Hi, Candace.

Candace: And Chris Hyzy, chief investment officer for Merrill Lynch and U.S. Trust.

Chris: Hello, Candace.

Candace: So, let's start with a look at what kinds of things can trigger volatility. Is there a normal for this kind of market behavior or is each episode of volatility different? Are algorithms to blame, are robots to blame? Michael?

Michael: There's always someone to blame, but that's normally after the fact, I think, after it's happened. And certainly, what you're touching on there is something that is certainly part-and-parcel of volatility, which is market structure, you know too many people excessively levered, and too many people, too bullish.

So, if you look at all the great volatility moments, market structure is certainly a big part of it, but you know at the end of the day, often volatility happens after you've had a great run in the market.

And guess what? After a great run in the market, interest rates start going up. And, when interest rates start going up, that's when you start to see the volatility.

Candace: So, Chris, the media often focuses on the size of the point drops when the markets are down. But, is that really what we should be paying attention to?

Chris: We are in a 24/7 media world. We probably were a decade ago, but we focus so much in that 24/7 on the actual price drop itself.

What's more important is the percentage drop because When you consider what a point drop is today on a much bigger base, a 1,000-point fall today, it feels difficult and painful, but it's a small percentage portion. If you go back to 1987, you had a 22% drop in one day.

And an equivalent 1,000 point move at that point versus now is drastically different. So, we have to look at the percentage versus the actual point drop, put it into perspective, also versus history, and make sense of why it's happening.

Candace: So, Michael you're well-known for your financial history work that you've done, particularly your piece, "The Longest Pictures." So, can you talk a little bit about the history of periods of volatility?

Michael: The three most memorable, past 30 years or so, 1987:

Newsclip: Today is Black Monday, the day the Dow dropped more than 500 points. Today the Dow dropped more than 22 percent, almost double the rate of the black Monday that signaled the beginning of the crash of 1929.

Michael: An awful crash that occurred when you had a period of currency volatility. You had a big spat between the Germans and the Americans in terms of policy and you had a market structure event as well in terms of portfolio insurance dragging the market very, very quickly lower.

Michael: But, it didn't lead to a recession. What it led to was a policy response and actually quite a rapid recovery in the market, very similar to '98. If you remember then, it was the Asia crisis that was the protagonist, but again, came after a long period of upside in the market. Currencies were involved, obviously. But again, the Fed rode to the rescue. Quickly cut interest rates again. Again, the U.S. economy barely registered that this event was going on, but on Wall Street, a lot of people were deeply affected by it.

So, I think in both occasions, when you get big volatility, big dips in asset prices, a lot depends on the policy reaction. You get a quick policy reaction, it's often safe to go back in. If you get a slow policy reaction, what the volatility is telling you is, that a recession's just around the corner, then you want to wait a little bit.

That, obviously was the case in 2008. What happened thereafter, there was a second collapse in the market simply because you also had to discount that something negative was happening in the real economy. So, policy and the economy, very important things to balance when volatility is going on.

Candace: So, I think what I hear you saying is that the stock market is not the same thing as the economy.

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| Michael: | No, I mean ... I can't remember who it was, someone very clever, once said, I mean, the stock market has predicted nine out of the past five recessions. I mean, it's often stock markets work off fear and greed and fear and greed cause overshoots and undershoots. But I think it's critical, to make a judgment as to whether what's happening on Wall Street has a knock-on effect to what happens in terms of corporate profits in mainstream. |
| Chris: | Yeah. Someone, a lot less clever said that the stock market is the neighbor to the economy. |
| Michael: | I think that was me. |
| Chris: | I was going to say it was me, but you can take credit for that one. And the reality is, you can watch your neighbor do certain things, whether it's in the yard, whether it's what they buy, how they carry themselves, etcetera, and the stock market will discount a lot of what that neighbor is about to do in future months and that's what the stock market is. It's a discounting mechanism for what is likely to occur in the proceeding months, if not years. And that's one of the reasons why volatility gets picked up there first and there's still low volatility overall in the economy and the economy is really, really large. It's a giant battleship that's hard to turn. The stock market tends to be a little bit more of a speedboat. |
| Candace: | So, before we move on, let's just be clear in terms of our nomenclature. |
| Candace: | How would you define a bull market and a bear market and what typically are the returns in a bull market and a bear market? |
| Michael: | Well, markets go up and they go down. And when they go down, either it's a correction, which can be a drop 10 percent to 20 percent or they can go down more than 20 percent, in which case, it's a bear market. So, every year, you |

often get pullbacks, which down 5 percent or so. You occasionally get corrections, which are down 10 percent or more. You rarely get bear markets, that's really once a decade is when you get a bear market. So that's the downside.

A bull market really is just a period of sustained gains in equity prices. I guess if you can get equity markets to new highs, then you really know you're in a bull market. But the other thing is the duration. Bear markets last 18 months. Bull markets can last eight, nine years. So, bear markets tend to be brief. Bull markets tend to be much longer.

Candace: Well, that's an important consideration when we think about steps and strategies that investors can take to position themselves...

Michael: Yeah.

Candace: ...for volatility. So, Chris, let's start out with you. When we're in the middle of one of those downturns, how can we resist the temptation for knee jerk reactions, because people want to do something. It's human nature.

Chris: Right. It's the most important question—because you have to have a plan going into whatever period you're going into.

Having a plan is not just about what I might do. It's about being ready to do something, and being ready is about what is your overall allocation versus the different asset classes.

Understand what your risk tolerance is, and when you're going through or in the middle of a downturn, be ready to look for catalysts to turn it around, stabilize and move the other way, understand whether or not this is a turn in the overall economy and the business cycle, and have a plan before you're going through it so you can act while you're going through it.

Candace: Well, that sounds like I have to make a lot of decisions. So, why don't I just move completely into cash until the volatility blows over?

Chris: The biggest issue with that is it requires four different decisions. It is, I have to go to cash. That's a market timing. How much? And then, I have to be ready to figure out when to go from cash back into what I had and how much. So, there's four decisions, versus having an investment plan that takes much of the emotion out of it and you understand what you're going to do in various parts of that episode.

Chris: One additional point to that is what is your expectation? Why are you going into investing in the first place? What are the goals? What are the objectives? Is it a particular event 10 years from now, 20 years from now? Is it retirement? Is it a second home? Is it your first home? Is it college education?

And, the power of compounding is very important. If you move in and out of the markets, you lose some of that power of compounding, and that's a very difficult thing to catch up towards. So, have a plan, have goals, maintain a diversified allocation across various asset classes, and investing is investing over time, not at a point in time.

Candace: Let's assume that I have a plan for the long term. What are some of the ways that investors can help cushion the impact of big market swings?

Michael: What I tend to think, if you believe that you've done very well. You've had a great couple of years, maybe you've exceeded your return expectations. It pays to be a little bit more prudent. Often that means, looking at things that haven't done as well. What you want to do is rotate a little bit out of the leaders, because the leaders are obviously, if they're up a lot, they're going to be a lot more vulnerable if there is a sell theme within the market. The other thing to do is just stay invested, but take the beater of your portfolio down. Again, you just have more defensive stocks rather than cyclical stocks within the portfolio.

Candace: We've been discussing the many factors that can cause volatility in the short term and how investors can navigate it. But, I'm curious if there are any sort of fundamental forces going on today that could change the nature of markets over the medium or long term? Are there any kind of forces that you see like that?

Michael: Without question. I mean, I think number one is inflation. Basically since 1980, we've lived through this period of interest rates falling-and-falling-and-falling-and-falling because inflation's been falling-and-falling, and that's been extremely good for asset prices.

So, if 2018 is actually 1968 and we're about to sort of move into a much more stagflationary environment, where inflation surprises to the upside, growth to the downside, there's more protectionism, international agreements get broken up; you get a shift from capital to labor in terms of the share of the economy. All of these things very reminiscent of back in the late '60s, obviously the clothes that we're wearing probably a little bit different from what we were back then.

But, nonetheless, that's something that clearly could mix it up a lot more. Geopolitics, is obviously a factor. Technology, like you say, is also a factor. So, you know, there's plenty of out there to think about.

Chris: I think taking cue from that, if you go back to the 1990s, it was about building the internet. In the 2000s, early 2000s, was about using the internet. But right now, it's about how do you store the information better? How do you create faster speed? How do you manipulate the use of what the internet provides you in a growth-friendly way?

And the question is, is who is going to lead within all of that and how do you take advantage of it from an investor's perspective? And we'll see more signs of that in the coming years.

Candace: Okay, final question for both of you, what are the big volatility triggers that you're keeping an eye out for?

Michael: Well, for me, it's the credit markets and to a certain extent, the currency markets too. I think again historically there's a lot of truth in the currency price. You know I think bond prices can be sort of manipulated somewhat by government buying and equity prices, to a certain extent, emotion can get involved there.

But, currencies, exchange rates are very truthful. I think if you start to see, particularly the Chinese Renminbi and the U.S. Dollar a lot more volatility in that exchange rate that is something that really would worry people, I think, in terms of upcoming volatility.

The other area is looking at government bond yields and corporate bond yields. If you start to see volatility or a widening of those levels, that would be seen as something that would be a reason to sort of take down risk and anticipate volatility.

Chris: Yeah, the credit markets, should show you the signs first that something is significantly changing. So, Michael is absolutely right. It's the credit markets and within the credit markets, it's what they call spreads. It's the spreads that corporate bonds have above sovereigns or treasuries.

It's the spreads within lower investment grade status versus investment grade status, and most importantly,-the spread between what the Federal Reserve may offer the banking system and then the banking system offers that out to other banks and other folks who lend.

So, you have to watch that. That is a key determinate of financial stress.

Candace: Well, great. Thanks, Chris and Michael, for your insights.

So to wrap things up, the key points to keep in mind about volatility are that it’s a normal part of market behavior … and a good way to prepare for it is to have a well thought out plan in place. A plan that takes into account your comfort with risk, your goals, and how long you have to reach them. And working with someone, like a trusted advisor, can help you come up with a plan that’s right for you.

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