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Special commentary
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Executive Summary

- Market dynamics changed in October, and the uptick in volatility has prompted concerns for investors. Despite the recent choppiness in markets, this year has not been abnormal from a volatility perspective.
- A combination of factors appear to be contributing to the recent risk-off environment. These include growing concerns about growth peaking, higher interest rates, U.S.-China trade tensions, and uncertainty stemming from the upcoming midterm elections.
- Although the pace of economic growth may have peaked in Q2, most economists expect that the economy has room to grow further, extending the current expansion to 2020 or beyond.
- While bouts of volatility can create angst for investors, short-term emotions should not drive one's investment decisions. Creating and adhering to a sound investment plan can not only help weather choppy markets, but can allow investors to take advantage of the opportunities they will present.

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Blog

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“Market Volatility Persists, but Not Unusual By Historical Standards”

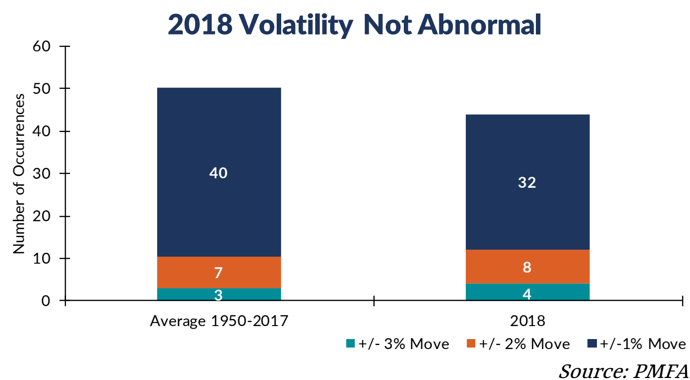
October is a notoriously volatile month for equity markets, and this year is no exception. Still, the volatility since the beginning of the year isn’t unusual in a historical context. To the contrary, it is much more like a typical year than not.

Volatility Reemerges

There has been a distinct shift in market dynamics in recent weeks that stands in stark contrast to the relatively smooth, steady climb that stocks experienced through the summer months. In fact, from late June to the end of September, daily market moves of the S&P 500 Index were fairly muted, never exceeding +/- 1%. That dynamic changed in October.

While October is a notoriously volatile month for equity markets, this month is on pace to be the worst one in a decade. Since October 1, the market has experienced eight trading days in which the market moved more than +/- 1%. Friday’s market decline of 1.73% not only added to that list, but it ultimately pushed the S&P 500 close to correction territory (defined as a 10% decline from its peak).

While harsh daily moves can be unsettling for investors, it’s important to keep recent market volatility in perspective. Comparing this year to historical averages, the number of sizeable market moves has not been abnormal. Since 1950, an average year has had roughly 50 days where the market moved +/- 1%, and in comparison, 2018 appears to be in line with those historical averages (as the chart illustrates below). The simple fact is that volatility and market corrections are not uncommon. Equity markets experience a 10% market correction in over half of all calendar years, but tend to end the year higher three out of every four years despite that intra-year volatility.



Source: PMFA

What has triggered the resurgence in volatility?

While there’s not one specific catalyst for the recent risk-off environment, a number of factors appear to be weighing into the shift in market sentiment.

- Growing concerns about growth peaking – both for corporate earnings and in the economy
- Higher interest rates, and apparent headwind to specific sectors (i.e. housing and autos)
- Growing concerns surrounding the impact of the U.S.-China trade tensions
- Uncertainty created by the midterm elections

While economic growth remains robust, recent data suggests that rising interest rates may be starting to weigh on certain areas of the economy that are more reliant on credit. Specifically, housing metrics and auto sales have recently shown signs of softness amid higher borrowing costs. At this point, the Fed appears undeterred from its path to normalization given a decades-low unemployment rate, inflation measures that are in line with its desired range, and other economic fundamentals that appear generally strong. Meanwhile, it's highly likely that the fiscal boost from tax cuts earlier in the year will wane in the coming quarters. As the impact of lower corporate tax rates begin to trail off, the earnings picture has also softened and earnings revision trends have deteriorated. Despite a softer pace of growth anticipated, there's a key distinction between slower growth and no growth. The pace of growth may have peaked in Q2, but economists still expect that the economy has room to grow further, extending the current expansion to 2020 or beyond.

Trade tensions create another wild card and area of uncertainty for investors. Beyond the direct drag on growth that tariffs can create, they have the potential to put upward pressure on input costs (potentially eroding profit margins), and can weigh on business sentiment (as an increasing number of companies have cited concerns about tariffs in earnings calls).

Finally, the upcoming midterm elections remain another source of uncertainty for markets. However, history suggests that the months following a midterm election have generally been positive for stocks (regardless of the election outcome), as we've recently illustrated in our Market Perspectives. While past performance is not indicative of the future, the upcoming election could remove a source of uncertainty and provide a boost to sentiment, which could ultimately be supportive for risk assets.

What should investors do?

We know that volatile short-term movements in equity markets can create angst for investors, but it's important that short-term emotions do not drive one's investment decisions. History has shown that long-term investors have been rewarded for taking risk. It has also shown that jumping in and out of the market can be a costly endeavor for investors. While volatility is an inevitable part of any market cycle, investors with a long-term plan in place are typically best equipped to navigate choppy markets.

Setting goals and investing in a manner that is consistent with your investment time horizon, tolerance for risk, and long-term return goals is critical. Outlining those decisions and investment parameters in a formal investment policy can help to provide not only a road map, but a foundation for disciplined decision-making. While there has been a distinct shift in market dynamics in recent weeks, a sound investment plan can not only weather these shifts, but take advantage of the opportunities they will present.

Disclosures

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