FEBRUARY 6, 2018

The Latest: Darkest before the dawn

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We see economic fundamentals are still improving. The sharp negative equity volatility is a buying opportunity for long-term investors, in our opinion.

The market downdraft of more than 600 points or over 2 percent on the Dow Jones Industrials Index on Friday of last week, followed by the more than 4 percent plunge or 1,100 points during Monday's trade erased the year to date gains that the month of January produced. Furthermore, as I write this, markets are down significantly on the back of weakness in Asia.

Why the severe and sudden downdraft in the markets?

Major market upward momentum to start the year became too over extended. Economic fundamentals are currently solid, corporate profits are accelerating, and investor sentiment rose to its highest levels in years. Investment flows began to sharply increase in equities in the last couple of weeks as enthusiasm over corporate tax reform took center stage. Then, a small flare gun went up into the air that began to spark concerns over inflation, rising yields, accelerating wage inflation, and the possibility that central bankers may have to quicken the pace of rate hikes.

In addition, the handover to a new Federal Reserve Chairman (Jerome Powell) and comments regarding over valuation in equities and real estate by policy makers added to the nervousness. Within a span of a few short trading days the entire gain of approximately 7.5 percent in the S&P 500 Index was wiped out and now in the red year-to-date. It took eight trading days to rise from 25,000 on the Dow to 26,000 and only two to remove that 1,000 point move.

As yield rose volatility in equity markets also increased. Since many investors worldwide have been geared toward low volatility (remember we didn't have 2 percent moves either way in the S&P 500 in 2017 and the US 10-year Treasury yield started the year around 2.4 percent and ended the year at close to 2.4 percent) there was a mesmerizing feeling that markets were going to keep on grinding higher as long as inflation remained in check and earnings outperformed and therefore complacency grew to excessive levels.

Once volatility began to rise, many investment programs started to re-calibrate and reposition. They began to re-balance for late cycle positioning in which inflation begins to rise, more cyclical investments outperform and typically central banks tighten policy more than expected. We have not been in this type of environment since before the credit crisis more than 10 years ago. This began the unwind of low volatility, lower yield and higher beta trades. Then the domino effect can take over in which institutional investors such as trend followers or momentum investors could begin to accelerate the downdraft by selling their market exposure.

Today's marketplace is more connected via quantitative investment programs than ever before and this can cause trends to become over extended. We saw this on the positive side in January when we traded up by more than 7 percent to begin the year and now we are experiencing the reverse in a sharper fashion. Some may call this a flash crash. We believe this is more akin to a market "backdraft" when a sudden small "known fear" (rising yields and inflation expectations) releases oxygen into the market which feeds on negative fears and causes a sharp downdraft due to the inter-connectedness of asset prices. This feedback loop can take on a life of its own in the very short-term due to the prevalence of quantitative programs, proliferation of index ownership, and the rising need to hedge exposure when volatility spikes sharply, in our view. High volume trading and excessive negative volatility when fundamentals have not changed for the worse can indicate short term bottoms, particularly when technical factors are a large reason for the downdraft. We don't think it's different this time.

What has changed fundamentally?

Nothing has materially changed in the last week, in our opinion. Economic growth is still gathering momentum in the US and overseas. Corporate profits are currently showing as healthy and as such we expect a 16 percent gain in them in the US in 2018. We believe financial conditions (real rates still low and the US dollar stable to slightly weak) are still attractive despite the expectation for a normalization of short-term rates. Emerging market consumer spending and capital equipment expenditures growth are still the engines of world economies. The only real change is that equity valuation just became more reasonable. The S&P 500's price-to-earnings multiple now stands at about 17 versus 19 times 2018 earnings. What a difference a few days makes!

As we stated before, the recent equity market correction indicates that the expectation of tighter policy is starting to weigh on broader financial conditions. The recent rapid ascent in global bond yields (who're coming back to earth late in Monday's trade) complicates matters for equity markets. So far, much of the increase in yields, however, has been driven by higher inflation expectations. This has actually kept real yields down, the real 2-year yields have actually declined in the Euro-area and Japan over the last several months. This is generally growth-enhancing not a warning sign that economies are about to struggle.

In our view, a small rise in yields, mainly based on rising inflation expectations due to higher growth, should be viewed as a good reason for yields to head higher and not a reason to suggest the bull market in equities is coming to an end.

So now with fundamentals still healthy and gathering positive momentum in the coming months, valuations about 2 points lower, 10-year Treasury bond yields only about 26 basis points higher at 2.7 percent versus the close in 2017, we view this volatility trigger and market backdraft as a buying opportunity for longer-term investors.

We do expect more short-term volatility in both directions as portfolios are further repositioned and quantitative programs are re-set but we believe investors may want to take advantage of these sharp weak periods by buying in a diversified manner across our preferred equity themes. We view this backdraft as the first substantive invitation this year to re-balance equity positions relative to strategic benchmarks upward.

It is important to put things into perspective. Low volatility years like 2017 should not be considered normal.

The S&P 500 enjoyed a boisterous start to the year, having capped off the best January performance in decades and approaching 400 days without enduring a 5 percent pullback. In addition, volatility remained close to record low levels. This is rather abnormal.

The current episode of volatility coincided with Q4 earnings releases, record equity inflows, and solid wage growth data that may indicate inflationary pressures to come. The pullback has bled across market caps and sectors, with bond proxies such as utilities and telecoms holding up the best. The treasury curve steepened with longer-dated yields picking up and the VIX, a market estimate of future volatility, jumped to its highest level (37) in years. During times of sharp corrections, it is important to maintain a historical perspective in order to stave off emotional impulses. Market pullbacks of varying degrees are relatively common across time, are typically shallow in duration, and have historically preceded subsequent melt-ups.

Trending bull markets typically do not ascend in a linear fashion, in fact, BofAML Global Research has found that the U.S. equity market has averaged three pullbacks per year of 5% or more over the past thirty years. Larger corrections are also not infrequent, with an average pullback of 10 percent or more on an annual basis occurring within the same

timeframe. Some retracements are longer in duration while most trough within weeks or even sooner. Since 1988 there have been 48 instances of the S&P 500 receding by 5 percent or more within the span of two trading days. However, while volatility may result in sharp pullbacks it may just as quickly contribute to subsequent boosts higher, as the 30-day price return following each two day pullback averaged 3.3 percent, dampening the effects of the downturn. Smaller ebbs occur at an even higher frequency, with the S&P 500 averaging eight trading days of -2 percent returns each year (see Table 1). While the last calendar year produced a strikingly single-sided advance higher, investors would do well to remind themselves that it should not be expected as the norm.

Human psyche ensures that it never feels comfortable to invest through periods of volatility or during a pullback, however the cost of rash action and opportunity cost of inaction can be crippling. Research examining the disproportionate effects on performance of the very best trading days has illustrated the striking benefits of maintaining a disciplined investment approach; excluding the best 10 trading days of each decade for the S&P 500 would result in a whopping 10,024 percent loss in performance since 1930. Likewise, the sizeable gains typically enjoyed during the twilight of expansions make it prohibitively costly to mistime an exit, with the final two years of bull markets producing a median return of 45 percent. While market pullbacks can be unnerving it is important for investors to recall that such episodes are not uncommon, may be dislocated from important fundamentals, and have shown to be frequently short in duration. A disciplined approach to managing a balanced portfolio remains the most potent solution towards helping to achieve your financial goals through the market's peaks and valleys.

Stay the course.

Chris Hyzy
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Table 1

Occurrences per year (From 1988–2017)				
Decline	**Average**	**Mininum**	**Maximum**	**Most Frequent**
≥ 2%*	8	0	41	0
≥ 5%**	3	0	12	2
≥ 10%**	1	0	3	0

* in a trading session
**peak-to-trough

Source: Strategas Research, BofAMLGlobal Research, GWIM Chief Investment Office

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