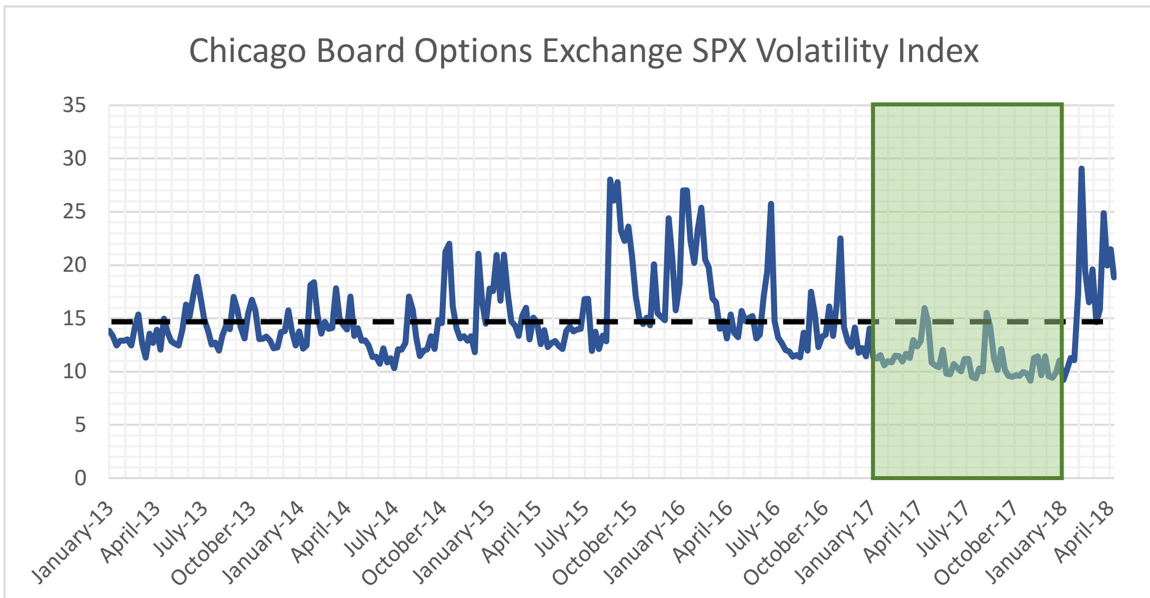
April 2018 Commentary

After an eerily smooth run-up since the Presidential election in 2016, volatility returned to the U.S. equity markets in the 1st quarter of 2018. For most of 2017, we felt like broken records, repeating that the lack of downside volatility was abnormal and, that by historical measures, we were overdue for a market correction (as defined by a 10% drop in value). In fact, prior to the 10.16 % decline in the Standard and Poor's 500 ("SPX") that began January 26th and ended February 8th, one would have to go back to 1960 to find a longer period without a 10% decline.

The correction should not have been a total surprise. In the 48 trading days preceding the market drop (from November 15th to January 26th), the SPX rose a remarkable 12.02% with very little downside volatility. Markets were up on over 60% of the days, with the average daily return being almost a quarter percent. Unfortunately, things have changed, and volatility returned in a significant way in the first quarter of 2018. One measure of market volatility is the Chicago Board Options Exchange SPX Volatility Index, more often known as the "VIX". The chart below depicts the return of volatility in 2018. The horizontal black line represents the average volatility over the past 5 years, while the green shaded box shows the lack of volatility in 2017.



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Bonds were not immune to selling in the 1st quarter. Fixed Income, as measured by the Barclays U.S. Aggregate Bond Index ("AGG") finished the quarter down 1.90%. This was only the third time since 2009 that both the AGG and SPX were negative in the same quarter.

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In 2017, the equity markets discounted any negative headlines and set 62 record highs. Thus far in 2018, the story has flipped, and headline risk has started to negatively impact equity and bond markets. More specifically, Trade War rhetoric has riled otherwise robust markets. While tariffs have, to this point, been mostly talk, the uncertain complexities that would be involved with retaliatory tariffs between the U.S., China and other trading partners have begun to concern the markets.

With that said, we place our focus less on the noisy headlines and more on how the overall economy responds to the Federal Reserve ("Fed") tightening monetary policy. We still expect the Fed to increase rates 3–4 times in 2018 (one rate hike has already occurred), with the Fed Funds rate likely ending the year somewhere around 2.5%. As has been the case since the financial crisis, we anticipate that the Fed will continue to telegraph its interest rate moves to avoid surprising the markets. We also expect that the Fed will remain patient and only hike rates as the economic data warrants.

As we continue into what will almost certainly be a more volatile year in equity markets, it's important to understand the benefits of portfolio diversification. Diversification occurs at many levels throughout a portfolio. Broadly, a portfolio is diversified between stocks and bonds to reflect an investor's risk tolerance. Historically, stocks and bonds have been negatively correlated, and allocating some portion of an investor's portfolio to high-quality bonds can help dampen volatility in times of equity market stress. Another layer of diversification occurs when International equities are added to a portfolio. Having exposure to economies outside of the U.S. has been demonstrated to help dampen portfolio volatility.

On a final note, with so much attention being paid to indexing investments, little is being said about how the composition of indexes change over time. The S&P 500 Index is market-cap weighted and, as the value of an individual company increases more quickly than the overall market, its weight in the index increases. At the end of the first quarter 2018, the S&P 500 Index had over 24% allocated to Technology companies; if you include Amazon as a technology company this number would rise to 26%. The five largest companies in the S&P 500 Index (Apple, Microsoft, Google's parent company Alphabet, Amazon.com and Facebook) account for about 14% of the S&P 500 Index. Those 5 companies are more impactful to the returns of the S&P 500 Index than the Health Care (14%), Industrial (13%) or Consumer Staples (8%) sectors!

One final note: As the volatility within the equity markets may have felt uncomfortable to some, just be thankful that you did not invest in Bitcoin. It was down over 50% in the quarter ☺.

Sincerely,

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Data Source: Bloomberg LP

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