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# WHITHER VOLATILITY?

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The S&P 500 rallied to new record highs in the second quarter of 2017, driven by the strongest corporate profit growth since 2011. Bond prices also rose during the quarter as long-term interest rates declined even as the Federal Reserve increased short term interest rates. While it is unusual to see stock and bond markets move in tandem like this, it may be more notable these returns were achieved while the volatility of both markets declined to extraordinarily low levels. With increasing fiscal and monetary policy uncertainty, the eerie calm that settled over financial markets in the second quarter left many practitioners anxious about investor complacency and pondering the implications of this unusual market activity.

Stocks and bonds typically have a low correlation, meaning that they do not tend to move in the same direction. Good news for stocks (improved economic or profit growth for example) tends to be bad news for bonds as it reduces demand for safer investments. When stocks and bonds move in unison as they did in the second quarter, the underlying cause is often a shift in monetary policy expectations. When the Federal Reserve ("the Fed") aims to stimulate the economy with lower interest rates, the result can be positive for both stock and bond prices.

This quarter, however, expectations for monetary policy stimulus have not increased. On the contrary, the futures market implies that the odds of an additional increase in the Fed Funds rate this year are now about 50/50 and slightly higher than where they stood at the end of the first quarter. The Fed has also begun to detail its plans to reduce the size of its bond portfolio, which was built to reduce long-term interest rates following the financial crisis. With the Fed reducing intervention in fixed income markets, short-term shifts in monetary policy expectations do not seem to be causing the simultaneous rise in stock and bond markets. One possible explanation may lie in the unusually low level of volatility that has been experienced in both markets as well.

Over the past six months, treasury yields have remained in the narrowest trading range since the 1970s, while implied stock market volatility (a common gauge of stock market fear called the "VIX") is near 20-year lows.[1] In some ways, this represents the culmination of a decade of experimental monetary policy that has herded investors into riskier assets. The Fed has reduced investors' ability to safely earn a return above the inflation rate with the goal of increasing all asset prices to spur a "wealth effect" that increases economic activity. This may have worked in fits and starts over the years, but now seems to be finally gaining sustained traction as an environment of low volatility and rising prices across almost all asset classes has arrived.

While the Fed's efforts to boost asset prices seems to be succeeding, it remains to be seen whether this will benefit the economy and the country more broadly. Artificially low interest rates can spur investment, but can also lead to malinvestment (the misallocation of resources into unproductive investments). A simple example of this is one of the few areas of financial markets that has seen some volatility this year: retail. Were it not for persistently low rates, it is possible that Sears and a number of other retailers would have already been forced into restructuring. With interest rates where they are, these weakened competitors have trudged on like zombies, waiting for Amazon to wipe them out instead. In the meantime, the entire economy must pay the price for these low interest rates as capital remains tied up in profitless endeavors.

The low level of volatility across most asset classes may also be exacerbated by other trends outside the Fed's purview such as the rise of passive and quantitative investing. As mechanized index investing and computerized algorithms drive more trading volume, the popularity of these strategies could create the same type of self-reinforcing herding effect as current monetary policy and further reduce volatility. If this is the case, then the risk of all assets correcting simultaneously is increasing. In this type of environment, diversification across asset classes may not provide much downside protection; investors who remain disciplined and do not follow the herd into excessive risk taking would be best positioned to take advantage of future investment opportunities.

While the low level of volatility in financial markets is worrisome, it is important to realize that this is not unprecedented. It has been more than six months since the S&P 500 dropped more than 2% in a day, which is the longest stretch in ten years.[1] The last time we saw market conditions so calm was prior to the financial crisis when monetary policy was running amok and excessive risk taking was quietly taking place behind the scenes. This environment persisted for 3½ years and ended more than 18 months before the fall of Lehman Brothers in 2008. As a result, it seems early to become alarmed by a short period of low volatility today. Instead, we are hopeful that the Fed will continue to execute its plan to normalize monetary policy before this period of low volatility sows the seeds of the next downturn.

In the constant battle between greed and fear in the financial markets, greed is certainly in the driver's seat at the moment. It seems to be time for the Fed to step in and instill some fear, lest the current driver become reckless and cause an accident. The result should be a healthier and more vibrant economy along with more volatile but fundamentally sound financial markets. Does the Fed have the courage to do what needs to be done? Does this require new leadership? These questions will become more pressing in the second half of the year. In the meantime, we expect that our disciplined approach to investing in high quality stocks and stable fixed income portfolios will serve our clients well as markets adapt to rising uncertainty.

**2017 MARKET DIARY**

| | | Last 3 Months | Last 12 Months * |
|---|---|---|---|
| U.S. Equities | | | |
| | S&P 500 | 3.09% | 17.89% |
| | Dow Jones Industrials | 3.95% | 22.12% |
| | Russell 2000 | 2.46% | 24.57% |
| | Russell 3000 | 3.02% | 18.50% |
| International Equities | | | |
| | MSCI World Index ex-US | 5.87% | 20.07% |
| | MSCI Emerging Markets | 6.38% | 24.17% |
| Fixed Income | | | |
| | Barclay's U.S. Int. Gov't/Corporate | 0.94% | -0.21% |
| | Barclay's U.S. High Yield | 2.17% | 12.70% |

Source: *Bloomberg Capital Markets* * Includes dividends for equity indices

[1] Garfield Reynolds and Adam Haigh, "Markets May Have Nothing Left to Fear but Fearlessness Itself," *Bloomberg*, June 26, 2017