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TRUST AND INVESTMENT SERVICES

Market Comment: Is this the return of Volatility?
August 11th, 2017

It has been an unusually long period of time without any pull-back in the markets or any meaningful volatility. Market volatility is the measure of dispersion between returns of a market index and results in rapid changes. We have not seen much volatility in sometime. The last meaningful pull-back was over 18-months ago, and since then the S&P 500 index has risen over 30%.

How did we get here? The political climate continues to produce little results. The lame duck years of the Obama administration have flowed into another administration. Although Trump's rhetoric is a little louder, we have not seen any substantial legislative change thus far.

We have seen a modest global expansion leading to subdued volatility. Global economies, in general, have improved as indicated by the International Monetary Fund's prediction on the world economic growth should be around 3.5% for 2017. This is a healthy number. As we have noted in other Market Comments, we look to the bond market first for indications on future economic changes. Yields around the world continue to remain low and, although the yield curve has flatten here in the United States (meaning the longer issue bonds are paying similar rates to shorter yielding bonds), the bond market continues to suggest we shouldn't expect much change.

So where will the volatility come from? We believe there are three main concerns that could cause a return of higher volatile: geopolitical risk, unwinding of the Fed balance sheet, and corporate earnings.

The recent developments surrounding North Korea and President Trump's stern warnings has jolted markets this week. Although we continue to believe outright conflict is a distant probability, the tensions have risen and will probably lead to greater uncertainty between developed nations and the Kim Jong-un regime.

The unwinding of excess money by central bank policy makers could create an issue for markets. The Federal Reserve (Fed) continues to telegraph every move, but questions remain whether or not it can unwind its balance sheet without affecting rates. On the Fed's side is the Consumer Price index (CPI), a measure of inflation, continues to remain subdued at 1.6% year-over-year for the most recent quarter. The Fed's 2% inflation target remains distant in the near-term, thus there is little probability of drastic interest rate move. But it should be noted that a more normalization of fiscal policy should send rates higher. This could cause volatility in stocks if investor sentiment shifts. The next Fed meeting is in mid-September and will be closely watched.

The recent move higher in stocks has been a result of corporate earnings. The S&P 500 index year-over-year Earnings per Share (EPS) growth continues to show strength. This trend of higher earnings will be more difficult to beat as we move forward. We think corporations may have a hard time with year-over-year comparisons. We expect companies to continue to perform well: however, margins could be challenged with increased labor cost resulting in less earnings growth going forward.

Excessive volatility comes from a shock or sudden change that was not predicted. Currently the global expansion and the lack of any major political policy shifts has kept volatility low. However, any geopolitical event, unexpected shift in sentiment relating to the Fed unwinding of its balance sheet, or a difficult earnings season later in the year could all lead to a sudden change. The probability of a major downward move seems slim in the near future, but one we remain aware of and will continue to monitor.