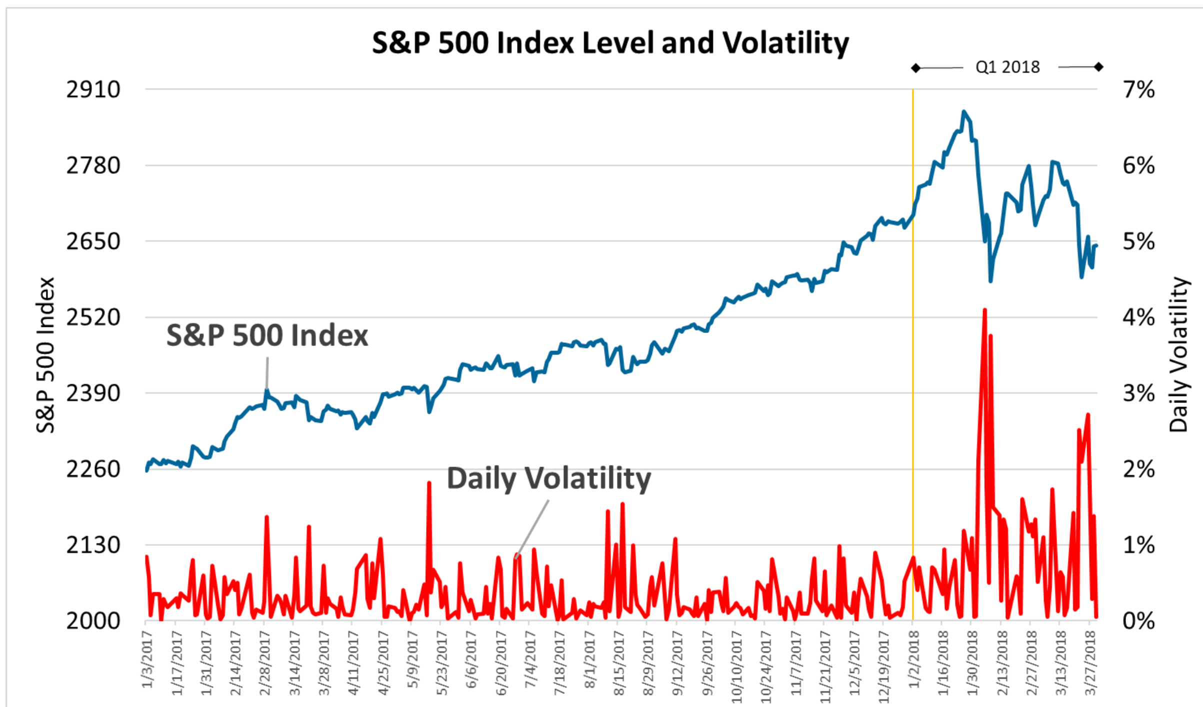
WAYPOINT
ADVISORS

Volatility is Back

In previous newsletters we talked about the eerie calm of the markets last year. In all of 2017, the S&P 500 index did not fluctuate more than 2% and it set 62 record highs over the year (the second most within a single year since 1990), ending up 21.8%. In contrast to the peaceful afternoon zephyrs of 2017, the first quarter of 2018 was a squall. Average daily volatility of the S&P 500 index jumped 355% in late January, with peak volatility in Q1 more than 1322% higher than the average from the prior 13 months.



Source: Morningstar, Waypoint Advisors. Daily volatility is calculated as the absolute value of the % change in the level of the S&P 500 index from the prior trading day.

Volatility May Cause Anxiety

Sudden shifts as we experienced in the first quarter of 2018 can be unsettling, especially after the long period of smooth sailing that we recently experienced. In 2017, with strong global economies, low interest rates, low inflation, and with consumer confidence robust throughout the world, risky assets had the opportunity to thrive. However, it is unusual for markets to go up so steadily without some kind of pull-back, so when volatility returned in early February it reminded investors of past periods of market unrest and caused anxiety about change and fear of loss.

While we believe the underlying fundamentals of our economy remain strong and that high-quality companies will continue to enjoy favorable growth, there are some concerns on the horizon that may continue to cause the markets to gyrate in the near future.

We describe these concerns as the 4 T's – tightening, taxes, tariffs, and technology.

What Happened? – The 4 T's

- **Tightening** – The Federal Reserve has made it clear that it is going to continue raising interest rates and reducing its 4.5 trillion-dollar balance sheet. By doing so, the Fed feels it will better accomplish its mission of "promoting maximum employment, stable prices and moderate long-term interest rates in the U.S. economy."[1] However, there is some fear that with the changing of the guard from Fed Chair Janet Yellen to Jerome Powell, the Fed could fall into its old pattern of overreacting to economic indicators and tighten too rapidly. This in turn would cause borrowing costs to increase and could cause inflation to spike. These knock-on effects could slow or stop growth.

  Tightening is also occurring in the labor market. Low unemployment is causing wage growth to increase which has a negative impact on the bottom line of most businesses. Additionally, labor markets are expected to continue to tighten due to a growing decline in the US work force caused by Baby Boomers retiring with fewer younger workers to take their place. Compounding this effect are more restrictive immigration policies and the increased demand for workers induced by the tax cuts enacted in late 2017.

- **Taxes** – At the end of 2017, the U.S. government enacted a sweeping tax overhaul. Uncertainty about the impact of the new tax bill, lack of clarity regarding government spending priorities and allocations, and heightened fears about the nation's deficit and increasing national debt all contributed to the volatility in Q1 2018.

- **Tariffs** – Although the discussion regarding tougher trade policies has been going on for some time, it was not until February 16, 2018 when the Commerce Department recommended that stiff tariffs be imposed on steel and aluminum that markets really took notice. Trade concerns have consumed the media and market pundits since then as the world tries to digest and prognosticate the impact of recent trade tariffs imposed by President Trump. The early U.S./China trade skirmishes have been testy and have thus far only led to international one-upmanship. A coherent trade policy has yet to emerge and market volatility has certainly reflected the daily shifts therein.

- **Technology** – While it would be natural to assume that technology stocks contributed to the negative returns that the S&P 500 index experienced this quarter, the tech sector actually had positive returns for the quarter of 3.5%. This might seem surprising because volatility in the technology sector certainly exacerbated the anxiety investors experienced. Technology stocks have historically been looked upon as where you invest when you are willing to take more risks for potentially large rewards. Valuations of high flying stocks are often based largely on their higher future growth prospects, making them more susceptible to greater declines when expectations are not met. The chart below illustrates how the technology sector appears somewhat tame compared to the period leading up to the tech bubble/bust, perhaps because the market environment (low interest rates, etc.) of the past ten years has been supportive of growth stocks. It is also true that many tech companies have matured into broader based companies and

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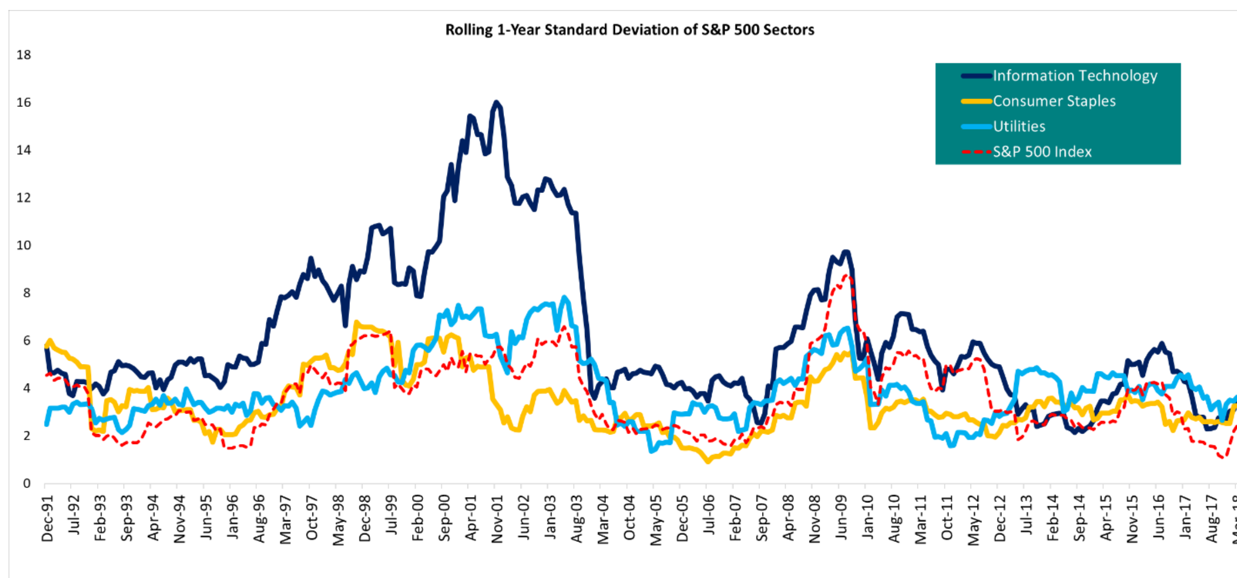
[1] Overview of the Federal Reserve System Section 1, page 1.
https://www.federalreserve.gov/aboutthefed/files/pf_1.pdf

hardly operate like tech companies anymore. Even so, tech is still more volatile than the combined sectors reflected in the S&P 500 index, a reminder that it pays to look deeper than the index at the sector risk/return tradeoffs to make sure they that are right for your portfolio.



Source: Morningstar, Waypoint Advisors. Standard deviation calculations are based on the price return of the S&P 500 index, and the Information Technology, Consumer Staples and Utilities sectors of the S&P 500 index.

A Healthy Correction

Volatility is a normal part of investing and can have a positive impact on the health of the markets. For example, corrections can reset stock prices to more reasonable levels. While the recent reemergence of volatility may have been disconcerting for some investors as the S&P 500 peeled off 8.7% from its high on January 26th, the effect in combination with strong corporate earnings served to bring valuations much closer to their historical average.[2] As illustrated below, the deviation of the S&P 500's current price to expected earnings over the next twelve months (Forward P/E) from its 25 year average is 86% lower than it was last quarter and 63% lower than it was two years ago.

S&P 500 Index	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018
Forward P/E	16.6	16.6	16.8	16.9	17.5	17.5	17.7	18.2	16.4
25Y Average Forward P/E	15.8	15.9	15.9	15.9	16	16	16	16	16.1
Difference	0.8	0.7	0.9	1	1.5	1.5	1.7	2.2	0.3

Source: J.P.Morgan Asset Management, Waypoint Advisors.
Guide to the Markets March 31, 2016 – March 31, 2018

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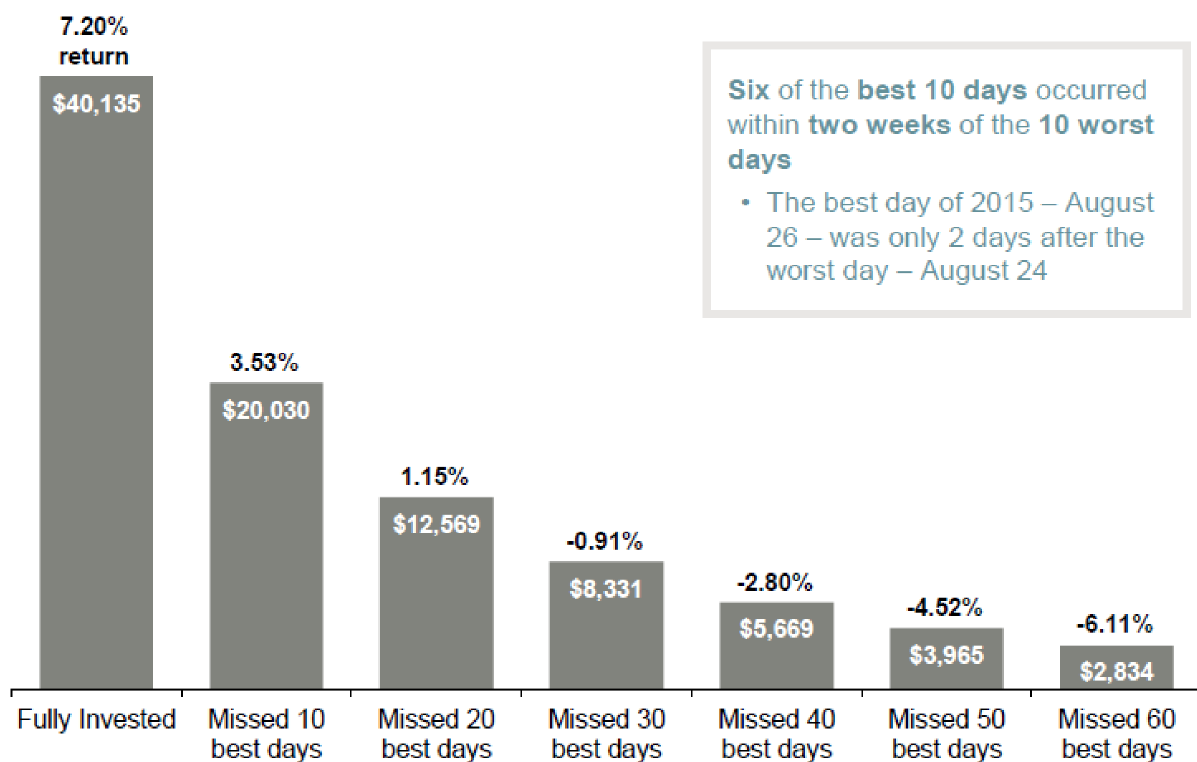
[2] The S&P 500 index peaked on 1/26/2018 at 2872.87. As of 3/30/2018 it closed the first quarter at 2642.31.

While times of market unrest may seem scary, volatility can actually tame the impulse to "irrational exuberance."[3]

Stay the Course

Experience teaches us to be cautious yet confident when seas get rough in the investment world. We learn that the best way to arrive at your intended destination is to plot a good course and to not over-react during unpredictable short-term squalls. As you can see from the chart below, the market's best days tend to occur close to periods of decline, so it is important to stick to your course and stay invested.

Returns of the S&P 500
Performance of a $10,000 investment between January 1, 1998 and December 29, 2017



Source: J.P.Morgan Asset Management analysis using data from Bloomberg.
Principles for successful long-term investing, pg 19. Data as of December 29, 2017

> **"It is not the ship so much as the skillful sailing that assures the prosperous voyage."**
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> *George William Curtis*

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[3] "**Irrational exuberance**" is a phrase coined by former Federal Reserve Board chairman, Alan Greenspan, in a speech during the dot-com bubble of the 1990s. The phrase was interpreted as a warning that the market might be overvalued.