A Quick Guide to Market Volatility

DECEMBER 19, 2018 **SUPPLEMENT**

As market volatility persists heading into year end, the question remains as to whether this new volatility regime is here to stay. While the uptick in the CBOE Volatility Index (VIX) has really just been a return to historically more normal levels (if not a bit higher), the recent increase has been jarring in the context of the historic volatility lows that investors experienced throughout 2017. Coupled with the difficulty the retail investor faces when trying to separate daily market activity and sensational headlines from longer-term economic indicators, drawing a concrete conclusion can be nearly impossible.

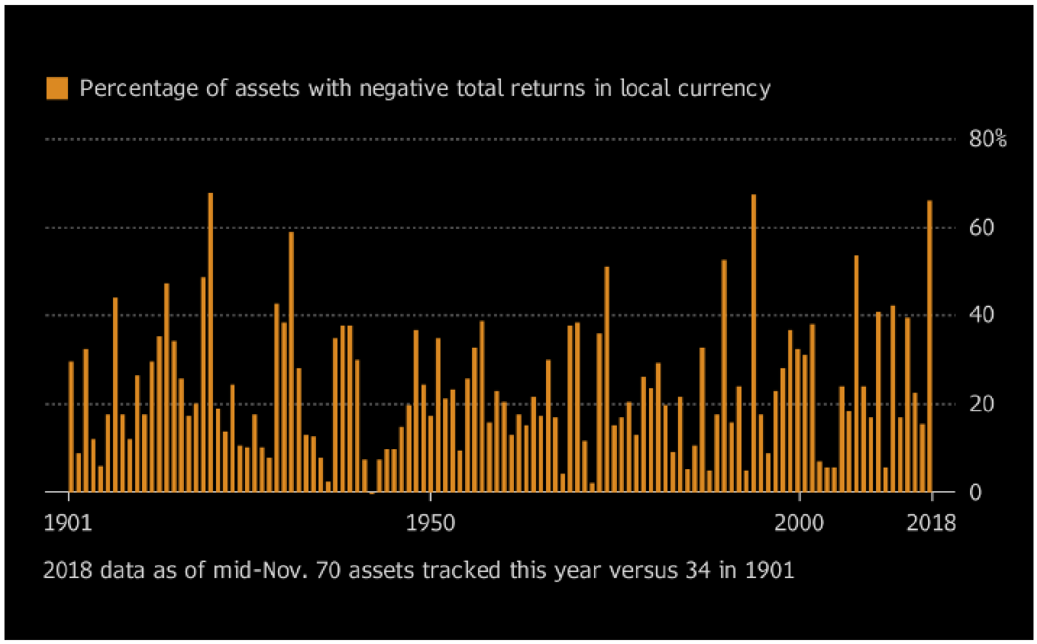

Figure 1

source: Deutsch Bank AG

One of the main reasons for much of the concern is that global markets have offered few places to hide in 2018. Typically, when one asset class suffers a market pullback, there are often other areas an investor can go to find reprieve. However, that has not been the case in 2018, as more than 60% of assets have experienced negative total returns through mid-November (see Figure 1). This may be surprising for U.S. investors, where two of the most well-recognized indices (S&P 500 and Dow Jones Industrial Average) have led global markets in 2018. Nevertheless, U.S. markets have been the exception and not the rule as international equities have come under pressure from tariff discussions this year and fixed income markets are on pace for their worst year since the early 1990s. Should this broad asset class pressure continue through year end, it will have been one of the most difficult years to find positive returns in over a century. No wonder individual investors feel so exhausted!

More recently, the uptick in volatility has captured the attention of news outlets and investors alike, sending people searching for an explanation for the selling pressure markets have seen in the fourth quarter. Unfortunately, it has not been as easy to find as it was in February 2018, when the implosion of the short volatility trade led to exacerbated market selling. The more recent moves have occurred as shifts across different strategies, almost like a series of baton handoffs between a variety of market participants.

Evidence of this can be seen by how disparate sector returns have been during the fourth quarter (see Figure 2). Note that different sectors led the market pullback each time, signaling selling from different investment styles from trend following strategists to

Sector	9/20-10/29	10/29-11/7	11/7-11/23	11/23-12/3	12/3-12/10
S&P 500	-9.9%	6.5%	-6.4%	6.0%	-5.5%
Materials	16.8%	10.5%	-5.0%	4.2%	-6.5%
Industrials	14.5%	7.8%	-5.1%	5.2%	-7.1%
Cons Discret	13.5%	9.3%	-9.3%	8.8%	-6.2%
Energy	12.5%	7.4%	-9.4%	5.9%	-6.8%
Financials	11.8%	6.9%	-4.8%	4.3%	-8.8%
Tech	10.8%	6.2%	10.1%	8.4%	-5.7%
Communication	-8.3%	6.2%	-7.3%	5.6%	-3.5%
Healthcare	-7.0%	6.4%	-3.9%	6.4%	-4.7%
Real Estate	-3.8%	3.2%	-0.4%	3.1%	-0.5%

Figure 2

source: Wells Fargo

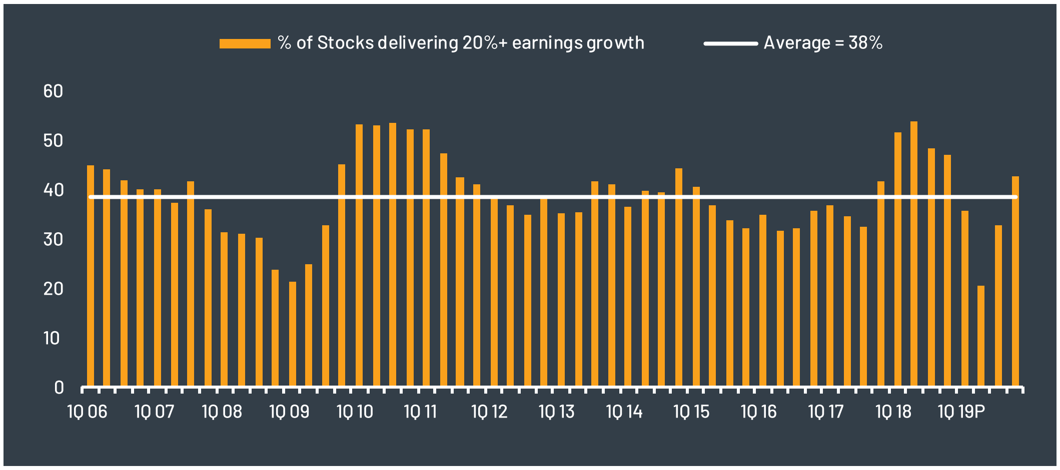

Figure 3

source: Jeffries

hedge fund managers to market technicians. This dispersion of returns stands in sharp contrast to a simple "risk-off" event such as August 2015 or February 2018, where systematic selling has driven market activity.

Despite this market activity and the challenging environment across broad asset classes in 2018, there are a few points worth noting that would suggest the outlook for 2019 remains positive. First, and foremost, the fundamentals remain strong. The economy is growing at a sustainable rate and labor markets are as healthy as they've been in decades. Inflation remains under control, below the Fed's target of 2%, which should allow for accomodative monetary policy heading into the new year. Corporate profits are still expected to exhibit strong growth into 2019 (see Figure 3) and equity market valuations are below historical long-term averages. Finally, behind-the-scenes progress towards a trade deal with China should only help stabilize markets heading into 2019.

All of these data points would suggest that it would be short-sighted to draw conclusions on the global economy from the confluence of volatility events markets have experienced during the fourth quarter without also considering the underlying fundamentals of global markets. While the uptick in volatility has startled many investors in recent months, it is critical to remember that markets are well within historical norms from a volatility perspective and that the outlook for 2019 should be based on more than just market activity that is fresh of mind.

We are actively monitoring market activity and will provide weekly commentary for as long as this market volatility continues. For any additional questions call our sales desk.