THOUGHT FOR THE WEEK
IS THE PARTY OVER?

SYNOPSIS

- Equity market volatility was practically nonexistent last year
- It returned this week with a vengeance, and investors are justifiably worried
- Concerns over a market correction and/or recession are mounting

IT'S BACK

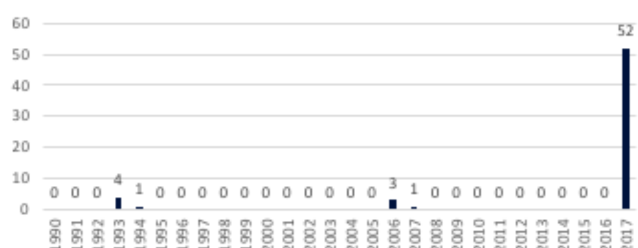
The Volatility Index (VIX) is computed by the Chicago Board Options Exchange (CBOE). This gauge is the de facto standard for measuring and tracking volatility, and many consider it to be the "fear gauge" for stocks.

A VIX level greater than 30 is generally associated with a large amount of volatility as a result of investor fear or uncertainty, while values below 20 generally correspond to less stressful, often complacent times in the markets.

The VIX hit an all-time high of 89 during the peak of the financial crisis, or over four times its long-term average of right around 20. This was a reflection of the panic and mayhem that rocked the U.S. equity market during the worst recession since the Great Depression.

Fast-forward the clock to 2017, and the VIX sat at all-time lows for a large portion of the year. To get a sense of just how low the VIX fell and how long it stayed there, the chart below counts the number of trading days that the VIX closed below 10, or half its long-term average, each year since 1990.

SUM OF CBOE VOLATILITY INDEX (VIX) CLOSES UNDER 10



Source: Bloomberg

Volatility was so low last year that the number of days the VIX closed below 10 was more than five times bigger than all the days combined over the prior 26 years. This unprecedented level of calmness in the stock market created a compressed spring that became increasingly unstable as we entered the New Year.

It's safe to say that over the last week, volatility has returned with a vengeance, and this rollercoaster has justifiably spooked a lot of investors. They are now asking if this volatility will lead to a correction in the stock market, or even worse, is a precursor to the next recession.

Before we address these two important questions, let's discuss three realities that equity investors must accept in order to achieve their long-term financial goals.

1. CORRECTIONS HAPPEN

A "correction" is defined as a drop of 10% or more in the value of an index. The table below provides some context around the frequency and severity of corrections in the S&P 500 from 1900 through 2017.

TYPE OF DECLINE	AVERAGE FREQUENCY*	AVERAGE LENGTH**	LAST OCCURRENCE
-5% or more	About 3 times a year	47 days	August 2015
-10% or more	About once a year	115 days	August 2015
-15% or more	About once every 2 years	215 days	October 2011
-20% or more	About once every 3.5 years	341 days	March 2009

Source: https://www.americanfunds.com/individual/planning/market-fluctuations/past-market-declines.html
** Assumes 50% recovery rate of lost value*
*** Measures market high to market low*

These numbers may appear frightening upon first glance, but consider three important facts:

1. **Corrections Happen**: Market pullbacks greater than 10% are not only common, they average out to be an annual event.

2. **They Don't Last**: Paper losses averaged less than a year and highlight the danger of selling into panic.

3. **Big Drops are Rare**: The S&P 500 does not fall more than 20% all that often. In addition to the data above, the index has only seen five drops greater than 30% since 1950, or roughly once every 13 years[1].

Since corrections do happen, let's dissect a stock price using the formula below to better understand their root cause.

Stock Price = Earnings + Valuation

Earnings are fueled by fundamentals such as economic growth, competitive positioning, management experience, and other factors that tend to change very slowly over time. Therefore, sudden moves in stock prices are almost never a result of an abrupt change in the fundamentals.

For example, if the stock market drops 10% in a month, it is highly unlikely that the average company's future profitability could change that fast. What *can* change is how investors perceive the value of an investment in the stock market.

Think back to the housing market in 2008, where it seemed as if the value of properties dropped overnight. This did not happen because homeowners suddenly realized that all the concrete used to build the foundation of their homes was poured incorrectly. Instead, buyers quickly left the market because they no longer wanted to buy or could qualify to buy a house.

The same applies to stock prices. Corrections almost always occur because of a sentiment shift by investors rather than any fundamental issue in the stock market because an economy simply cannot move fast enough to drive that much of a change in price.

Simply put, corrections happen but rarely persist for too long because the fundamentals tend to remain intact.

> **"...the real danger that exists right now in markets is not the volatility but rather how this volatility will cause investors to react."**

2. THE MARKET IS A MYSTERY

One big question on investors' minds was why the market sold off so hard at the beginning of the week, and the financial media seems to be blaming rising inflation expectations. While this very well may be true, the reality is that this is nothing more than an educated guess.

Market pundits are obsessed with understanding the short-term movements in equity markets. They want to explain why stock prices are rising and falling every moment of the day because those who can provide more color (another word for "insight" on Wall Street) are regarded as having a good "feel for the market."

However, stock exchanges do not require participants to explain why they buy or sell stocks, and large asset managers even go out of their way to maintain anonymity by trading in "dark pools," which are special venues where nobody knows who is on the other side of a trade and activity is kept secret.

Instead, market commentary comes from a mix of sources that are frequently unreliable, such as large trading firms on Wall Street that execute big orders for their clients. These traders move millions of shares

Global Financial Private Capital

every day, which allows them to see the flows up close and personal. The problem is that since most of the trading is electronic these days, their insight only explains the tiny fraction of the overall volume.

Rather than admitting that they do not know why stocks have risen or fallen, a commentator's only option is to concoct an explanation that seems logical and well-informed but is nothing more than a guess. That way, they remain the market guru and none the wiser.

Simply put, nobody really knows for sure why volatility spiked this week, but since explanations on daily moves offer very little value to a fundamental investment strategy, they can be safely ignored.

3. A STRONG STOMACH PAYS

The chart below shows that an investment of $10,000 in the S&P 500 on January 1, 2008 would have grown to over $22,000 by December 31, 2017. More than doubling your money with an average annual total return of 8.5% in less than a decade is not too shabby, but this chart also highlights what an investor would have had to stomach along the way.

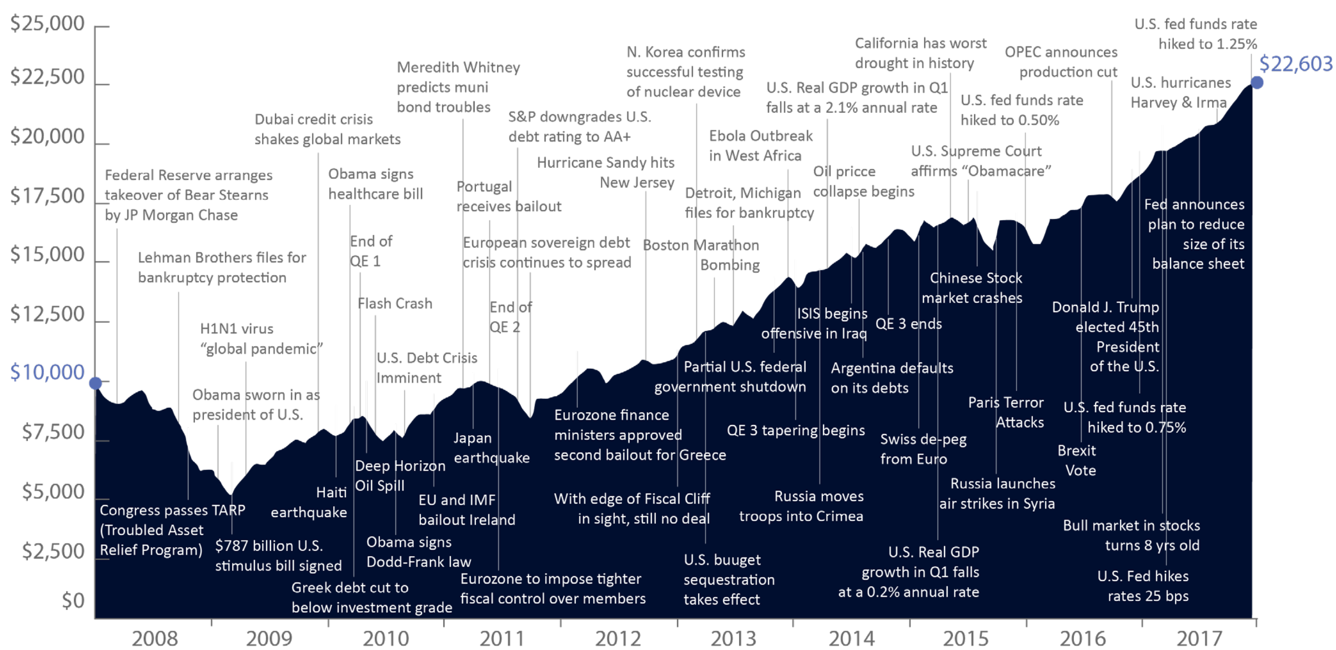
The ultra-low volatility in 2017 made it easy to forget that stocks are volatile investments that react to events that are equally unpredictable. Managing emotions through these rough patches is the price an equity investor must pay to achieve similar results to this chart.

Volatility is a measure of the short-term movements in stock prices. Since the day-to-day ups and downs are driven by emotional reactions to events like the ones in the chart above, then by association, volatility is a measure of emotion.

Hence, when the stock market gets more volatile, it is really just getting more emotional, and emotions cannot derail a $20 trillion economy. The world does not end all that often, and investors with a strong stomach and who can keep it together during these pockets of volatility have historically been rewarded.

IMPLICATIONS FOR INVESTORS

Add it all up and the answer to the first question posed



Source: First Trust Advisors L.P.[2]

above is that I have no idea if the volatility will lead to a correction next week, next month, or any other time in the near future. Timing these events is impossible, but don't just take my word for it. Peter Lynch, one of the most successful investors of all time, said it best:

> *"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."*

The second question about the rising risk of a recession is easier because while there has been a lot of media attention around what changed to cause so much volatility, little time has been devoted to what has not changed. Here are a few that come to mind:

- **Strong Economy**: Economic data continue to be strong and point to future acceleration.
- **Accommodative Fed**: The Federal Reserve has indicated no intention of slowing down our economy.
- **Corporate Tax Reform**: The volatility has not impacted this game-changing legislation that could act as an adrenaline shot to our economy as early as this year.

As explained earlier, the U.S. economy is analogous to an oil tanker, where course corrections take a long time to complete. The economic growth that we are experiencing took years to cultivate, and it will take way more than a little panic in the equity market to derail.

Hence, the risk of a recession remains low, and the volatility this week changes nothing to my investment outlook for 2018 and beyond.

THE BOTTOM LINE is that the real danger that exists right now in markets is not the volatility but rather how this volatility will cause investors to react. Keep emotions in check and remember what drives stock prices over the long run.

SINCERELY,

Mike Sorrentino | CFA
Chief Investment Officer
Global Financial Private Capital

[1] Bloomberg, Global Financial Private Capital analysis

[2] https://www.ftportfolios.com/Common/ContentFileLoader.aspx?ContentGUID=a92e742e-ce4d-4bd2-810a-b053263e414f

The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.

This material is for informational purposes only and sets forth the views and opinions of our investment managers as of this date. The comments, opinions and estimates are based on or derived from publicly available information from sources that we believe to be reliable. This commentary is not intended as investment advice or an investment recommendation nor should it be construed as a solicitation to buy or sell securities. All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not include fees or expenses. Past performance is no indication of future performance.

Investment advisory services offered through Global Financial Private Capital, LLC. Securities offered through GF Investment Services, LLC. Member FINRA/SIPC. 501 North Cattlemen Road, Ste. 106, Sarasota, FL 34232. 423269