Quarterly Newsletter

First Quarter Review: All Was Quiet, Then It Wasn't

January 2 was the first trading day of 2018, and it looked just like the last few weeks of 2017. Nearly absent volatility and a relentless push upward characterized most of January. The S&P 500 set record after record – an astonishing 14 new highs in the first 18 trading days ending on January 26. And then the music stopped. By the end of the week the benchmark index had retreated nearly four percent from that 1/26 record high, most of which followed a jobs report showing a higher than expected pick-up in wage growth (a potential inflationary catalyst). Less than a week later, the pullback had morphed into a full-on technical correction, down 10.2 percent from the high. Volatility was no longer missing in action; the CBOE VIX index, the market's so-called "fear gauge," registered actual fear for the first time since 2016. To compound investors' jitters, the Treasury bond market shut its doors to seekers of safe havens. The 10-year yield spiked throughout most of February on those same inflationary fears, threatening to breach 3 percent. Geography was also no help, as both developed and emerging markets took their lumps.

In March, any remaining hopes for one of those tried and true V-shaped recoveries – where prices recover their losses and go on to new highs before anyone has even processed their being down – were dashed by a new narrative: threats of a trade war. A blustery declaration of new tariffs on steel and aluminum by the US administration won a few cheers in beleaguered Rust Belt towns but alarmed our major trading partners. Every time things seemed to be calming down and heading for the negotiating table, another spate of ill-considered verbal spasms threw markets and rational-thinking people into yet another paroxysm of confusion. Whatever news was helping to drive prices higher or lower on any given day was magnified by the volume of algorithmic trading – quantitative strategies hardwired to automatic buy and sell triggers – dominating the daily share volume flow.

For all the *Sturm und Drang* of the last two months of the quarter, though, the damage in value terms was relatively constrained. The 10.2 percent retreat recorded on February 8 turned out to be the low point for the S&P 500; it would flirt with that level again on the first trading day of April but then go on to another rally. It is probably not surprising that popular technical indicators like the 50 day and 200 day moving averages tended to be the points around which selling waves and relief rallies clustered – these, after all, are the domain of those always-present quantitative trading strategies. Meanwhile, the bond market settled down after that frenetic February. The 10-year yield has mostly stayed below 2.9 percent, and credit risk spreads between Treasuries and corporate bonds have not widened appreciably. The dollar has mostly marked time against other currencies, oil prices have rallied and investors haven't piled into typical risk-off assets like gold.

Second Quarter Outlook: Living With Volatility

So does this mean that the worst has passed? The short term, of course, is unknowable. We may or may not be in for another round or two of ping pong between technical support and resistance levels. Currently, though, the price trend chart for the S&P 500 looks quite a bit like the one in January-February 2016, the last time we experienced a pullback of 10 percent or more. The story back then was fear of a hard landing in China. After a couple months of jitters the collective wisdom gelled around the notion that things weren't as bad as they might have been, and risk assets went on to rally. The conventional wisdom would seem to argue for a similar outcome this time. Neither February's inflation theme nor the trade war talk in March seem to have a compelling hold on investors' minds. Subsequent data to that February jobs report suggest that inflation remains contained – the Personal Consumption Expenditure index, which is how the Fed gauges inflation – is at 1.6 percent, i.e. still below where the Fed wants it to be. Negotiations and empty posturing still seem more likely than an actual ruinous trade war between the US and its trading partners. Meanwhile, little else has changed in the dominant macroeconomic landscape. Most of the world continues to grow at modest rates of output with healthy job markets. Corporate earnings are in robust health. The current consensus estimate for Q1 earnings per share is around 17 percent year-on-year. None of this suggests the kind of structural damage that could precipitate a more sustained downturn in asset prices.

That's the (probable) good news. The likely bad news, for those who prefer not losing sleep over their portfolios, is that higher volatility seems to be settling in for a while. This is faintly reminiscent of 1998, when volatility rose considerably after a couple benign years. Asset prices continued to climb, but that year saw more pullbacks and wider intraday spreads. And, again, the larger role played by algorithmic trading today could exaggerate the volatility even more. Investors will need to remain disciplined and keep fear under control when and if more of these roller coaster episodes occur.

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