MARKET COMMENTARY

INVESTMENT STRATEGY GROUP
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Clarity and Confidence in the Face of Market Volatility

Backdrop

The stock market dropped nearly 8% from recent January highs. It has bounced back to some extent, but volatility is still elevated to levels we haven't seen in a few years. Briefly, over the past few days we have seen the following:

- Global stocks declined 5-10%
- Bond yields increased (10-year Treasury spiked to 2.85%)
- Volatility briefly increased to the highest level since August 2015

News outlets and investment management organizations are frantically trying to explain the drop in stock prices, but most are telling different stories. There are a plethora of causes that may be blamed for the decline. We will not attempt to pick the specific culprit, but we do believe there are several pressures that have been mounting:

- An expected expansion of fiscal stimulus in the economy has not been met with equal monetary stimulus. The Treasury is set to increase its bond issuance due to the newly passed tax reform while the Fed is scheduled to start reducing its balance sheet this year. This expected increase in supply against stable demand could be contributing to higher bond yields.
- Strong economic growth, earnings upgrades, and concerns over wage inflation are potentially causing markets to adjust their expectations about Fed rate hikes upward. This contributes to higher yield expectations.
- Market prices are rationally moving closer to long-term average valuation levels.
- Investors are potentially selling their shares following historically fantastic stock market performance.
- All of these factors have been spelling trouble for the leveraged exchange traded products as they are forced to readjust their portfolio positions in light of the quick price moves, inflicting volatility on the markets.

In the face of all this uncertainty, it makes sense that volatility has returned. It is more surprising to us that volatility has been so muted over the last two years. Volatility was tracking at almost a third of what it has been historically. The return of volatility is a good catalyst to revisit how investors are positioned and ensure there isn't an inappropriate amount of risk in meeting future financial goals.

Our View

Focusing on your financial goals is likely the best way to have clarity and confidence when market turmoil arrives. Volatility is one measure of risk that tends to receive an overwhelming amount of air-time, and is defined as how much an investment's price can change in the short-term. While this can be helpful when comparing investments with each other, it has very little impact on most investors' financial goals. In fact, if an investor is investing for 10 years or more, volatility is welcomed and the very reason investors earn a return at all. Rather than thinking about a portfolio as a whole, investors can benefit by thinking about when they will need to tap the investments to fund future financial needs. With that backdrop, here's a quick guide on how to think about the recent volatility for money needed for various time horizons:

Money needed in more than 15 years should likely be significantly, if not completely, invested in a globally diversified stock portfolio. The recent volatility should be welcomed as it creates relative and absolute valuation discrepancies. However, volatility is not a good measure of risk for very long-term investment needs because it has no bearing on long-term returns. The larger risk is the opportunity cost of not being exposed to growth-centric assets, like stocks. Since 1919, there have been 10 market drawdowns of greater than 20% (inflation-adjusted). On average, it has taken just six years to get back to the peak. While not a guarantee, it can give an investor confidence that, if they have a long enough time horizon, volatility is not a very relevant measure of risk.

Money needed in 10 years should be largely invested in a globally diversified stock portfolio, with the ability to add real assets and bonds depending on the economic environment. Real assets like gold and commodities are often used to hedge some of the risk of inflation or policy missteps. An allocation to bonds, when priced attractively, may also be suitable for cash flow needs in the 10-year time frame. The important aspect about this particular time horizon is the ability to adjust the portfolio across asset classes and regions.

Money needed in five years should not be heavily exposed to the stock market due to the volatile nature of equities. The predominant investment for this time horizon is bonds. However, the ability to invest in stocks and real assets may be important depending on the economic environment. The important aspect for this particular time horizon is the ability to adjust the portfolio across asset classes while keeping in check the overall portfolio's volatility levels.

Money needed in the next couple of years should not be exposed to the stock market at all because too much of the return will be driven by market sentiment and not by market fundamentals.

Conclusion

Focusing on future goals and allocating investment assets based on when the money will be needed allows investors to have confidence about their financial life. Without the guideposts of goals, it can be difficult to assess whether volatility can or should be tolerated. Setting aside reserves for the shorter time horizons allows investors to capitalize on volatility rather than react to it. It is important to remember that volatility is normal in the stock market and is the very reason why long-term investors are compensated for buying stocks.

We hope this helps put into perspective the recent market events. If you have any questions or concerns, please contact your Ronald Blue Trust financial advisor for more information or to schedule a discussion with one of our investment strategists.