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Market Volatility Update - February 6, 2018

GYL believes that despite the recent elevation in capital market volatility, further sell-offs may be limited by the general health of the global economy.

Yesterday, the CBOE Volatility index (VIX), a measure of expected swings in the S&P 500, jumped to 50.30, its highest level since August 2015. This felt particularly uncomfortable due to the fact that for most of 2017 and early 2018 the VIX was closer to 10. Accordingly, the contrast for most is a bit jarring. It is important to remember that volatility, and the corrections like the one we are witnessing, is a normal part of the capital markets. On Tuesday, February 6, 2018, during the early portion of trading period, the Dow Jones Industrial Average moved into “correction” territory while the S&P 500 is on the cusp of a “correction”. A “correction” is defined as a decline of greater than 10%. It is within the realm of possibility that we may add to these cumulative declines in the coming days.

What is causing the recent decline?

There are a variety of pundits that claim to have a priori access to knowledge and profess to have the capability to tell you when markets will move and then precisely why they did. We do not profess to have such insight. With that being said, we can point to a variety of contributing factors that we believe have played, and will continue to play, important factors in the direction of travel for the capital markets.

One such contributing factor is the recent rise in interest rates.

Whether as a result of policy action by the Federal Reserve and/or by virtue of market forces, the shape of the interest rate yield curve matters.

a. As interest rates increase, fixed income becomes a more attractive investment option for certain investors. This is particularly true as volatility increases in equity markets. This in turn can lead to net outflows from equities into fixed income;

b. Rising interest rates contribute to increased financing costs for individuals and companies alike, thereby decreasing disposable income and/or net earnings. This in part can act as a head wind to further increases in equity market valuation since earnings are an essential component connected to market valuation; &

c. Rising interest rates are relevant to the present value of earnings streams associated with companies. As interest rates rise, the present value of future earnings streams decreases and therefore the price (multiple) that investors are willing to pay for companies’ earnings stream decreases.

What is important to remember is the following:

a. This too will pass;

b. Corrections in markets can be healthy. They peel away excess market valuation and help market participants to remember that this is not a risk free environment. This is good because when market participants operate as if the capital markets are risk free, they tend to allocate capital inefficiently and become more aggressive than what is appropriate; &

c. The underlying economy is actually growing more than it has in recent years;[1]

The key to managing through periods of elevated volatility is to maintain diversified portfolios that are tailored to an investors' willingness and ability to assume various levels of risk. As always if you have concerns or would like to schedule some time to review your investment or financial plan(s), please let us know.

IMPORTANT DISCLOSURE

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[1] According to the US Department of Commerce Bureau of Economic Analysis's "National Income and Product Accounts Gross Domestic Product: Fourth Quarter and Annual 2017 Report". More information can be found at: https://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm