February 2018

Investment Insights

Observations on recent market volatility

Ellwood's Capital Markets Committee

Volatility has returned to global equity markets. This perhaps isn't entirely surprising after a sizzling 2017 in which the S&P 500 generated a total return of 22% with record low levels of volatility. In fact, the S&P 500 generated losses of 1% or larger in only four trading days during 2017; the last time this happened was 1995.

The decline of 4.1% on February 5 was the largest since 2011, a period marked by Standard & Poor's downgrade of the AAA credit rating for U.S. Treasury debt and the Eurozone debt crises. But unlike 2011, the world today is enjoying a level of synchronized global economic growth not seen since before the 2008 financial crisis, providing a tailwind to equity and credit markets.

As noted in Ellwood's 2018 Investment Outlook, we anticipate that the confluence of solid global economic growth, stimulative tax policy, and low unemployment could set the stage for above-consensus inflation in the U.S. Recent inflation data is beginning to support this view. Combined with a slightly more hawkish press release from the Fed's January 31 meeting (i.e., expressing new concerns over inflation), markets have started to price in a higher probability of the Federal Reserve accelerating its path of rate hikes. Markets enjoyed a massive dose of stimulus from global central banks since the financial crisis through their low interest rates and quantitative easing regimes. Now, the market is adjusting to a world in which central banks move towards normalizing monetary policy. This may be particularly troublesome with valuations across many asset classes trading at levels well above historical averages.

While the volatility is unsettling, fundamental economic drivers of growth do not change overnight. While financial conditions bear watching, as they can influence or be predictive of the future direction of economic growth, Ellwood is not yet envisioning a short-term scenario of this volatility leading to a recession. Volatility is a normal component of long-term investing, and this past week's market activity is much more typical than the unusually low volatility environment in 2017 we enjoyed so much.

We will continue to monitor the impact of volatility on capital markets and will report back to you with material changes in our investment outlook. That said, our focus will be on the longer-term impacts as opposed to the daily, short-term volatility we are seeing today. In the interim, please let us know if you have any questions or would like to discuss further.

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