

Enter Volatility

After a calm 2017 and first month of 2018, February has reminded investors that the potential for higher returns with stocks also comes with the potential for higher volatility. Often volatility signals a change in leadership.

For the past 35 years interest rates have declined and the bond market has been in a bull market. After the 2008 financial crisis income strategies which focused on bonds and higher dividend paying stocks have rewarded investors. Recent fears of deflation only supported the trend.

However, in early 2016 the global economy began to reflate and now inflation is beginning to make headlines again. The deflation story is over. Something is changing, the economy is getting stronger and the decline in interest rates is over. When interest rates rise, income strategies will no longer work. New leadership will emerge.

Yes, higher inflation and interest rates can be a headwind to both stocks and bonds. However, if the economy gets stronger, that should lead to higher corporate earnings to support equity prices. We have yet to see the full impact of the recent tax overhaul and currently U.S. lawmakers are discussing a massive infrastructure spending plan.

Based upon historical numbers, we have been overdue for a pullback. According to the Wall Street Journal, the S&P 500 in January posted its longest streak of monthly gains in almost six decades. Although they are painful to experience, stock market corrections are part of the investing experience. Typically, we experience a correction of 10% or more about once a year. It had been two years since the last one.

We would not be surprised to see a few more days of selling pressure. During times of market stress, various investment strategies and products end up on the wrong side of the trade which causes forced selling. We believe we have witnessed that happening throughout the week. It will take some more time for the market to adjust to the change in trend and the forced selling to alleviate. Once that is complete we believe the market will once again focus on the economy.

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