CAPITAL ADVISORS

**RESEARCH UPDATE**
February 6, 2018

## Thoughts on Recent Market Volatility

The key point we hope to convey in this commentary is that investors should have the luxury of time to implement changes to their investment strategy, to the extent that changes are necessary at all. For most investors, we believe doing nothing may be a perfectly sensible strategy for the time being.

Today's *Wall Street Journal* offers a thoughtful review of the recent eruption of volatility in the asset markets. Writer James Macintosh notes that "The recent market plunge feeds two narratives, one of which could be really bad news."[1] We don't expect the "really bad" scenario to play out, and we will explain why, but it is helpful to understand the concern.

Both narratives involve interest rates, which are almost certainly the catalyst for the recent market spasm. In the benign scenario, global asset markets are assumed to be in the midst of a necessary adjustment to tighter credit conditions. Specifically, domestic credit markets reacted to a recent stretch of strong economic data by repricing the likely path for central bank monetary policy.

We can quantify this assertion objectively through recent price action in the futures market. Even though the Federal Open Market Committee (the Fed) has been signaling for more than a year that it expects to raise interest rates three times in 2018, prices in the futures market suggested that consensus opinion did not believe them. That changed last week, when futures prices shifted from pricing in less than three rate hikes in 2018, to about a 20% probability of *more* than three.[2]

The benign narrative for recent market volatility assumes that a repricing of monetary policy expectations was necessary, but financial markets can settle into a new trading range without significant lasting damage once volatility subsides. This would be a fairly normal credit market adjustment to an improving economy.

Unfortunately, "normal" is a poor description for recent wild swings in the stock market, so we need to ask what else might be going on. This is where the "really bad" narrative comes in. The plotline for this scenario is inflation.

No one knows where inflation is headed, but those inclined to worry about it can build a convincing case: Nine years of extraordinary monetary policy just gave way to a massive fiscal jolt in the form of lower corporate taxes. Animal spirits seem to be percolating. Economic data is strengthening, and for the first time since the financial crisis, core inflation is showing signs of life.

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[1] Source: Wall Street Journal, "Steep Selloff Can End Two Ways," Feb. 6, 2018
[2] Source: CME

Inflation expectations are important to what happens next because of their impact on *long-term* interest rates. If investors come to believe inflation is likely to accelerate, not only will they demand higher interest rates at the short end of the yield curve to account for tighter monetary policy, they might also demand a higher "term premium"[3] for longer term bonds as compensation for uncertainty about the future path of interest rates.

Nine years of stagnant inflation and highly telegraphed Fed policy (not to mention a few trillion worth of quantitative easing) have supported a shallow term premium for bonds since the financial crisis. This regime of ultra-low interest rates has been highly supportive for <u>all</u> asset markets because interest rates are a foundational input into the valuation calculation of every asset class – stocks, bonds, real estate, etc. Recent market action suggests that investors have begun to doubt their assumptions about inflation, resulting in higher interest rates than most market participants were expecting as recently as 60-days ago.

The reason we advocate patience for investors despite this uncertainty is because inflation is a process, not an event. To the extent that the recent correction in stocks foreshadows a more troubling future for inflation, it should take time to play out because the data investors rely upon to measure inflation unfolds slowly.

In this same vein, we note that nothing broke to trigger the recent jump in volatility. Quite the contrary, the rise in interest rates *so far* seems perfectly justified by the current backdrop of healthy corporate profits, accelerating economic data, and a step-change higher in expectations for businesses capital spending due to the incentives embedded in corporate tax reform.

While it is possible that a pickup in global growth and employment might trigger a destabilizing jump in inflation, we do not believe it is likely. We are happy to share supporting evidence for this perspective with anyone who wants more detail (respond to this email if you want us to send it to you). For everyone else, suffice it to say that we believe aggregate supply has been expanding faster than aggregate demand for most of the past two decades due to countless efficiencies and innovations associated with the penetration of the digital revolution throughout the global economy.[4] If this thesis is correct, inflationary pressures seem likely to remain subdued for many more years because the pace of adoption for major technological innovations shows no signs of slowing, in our opinion.

We conclude by suggesting that the regime of ultra-low interest rates that persisted from 2008 to 2017 is no longer consistent with the current backdrop for the global economy. A transition to higher interest rates can be considered normal and healthy under the circumstances. Unfortunately, it is also normal for investors to question whether rising interest rates can coexist with economic prosperity. The future path of inflation may determine the answer, and we expect financial markets to bounce around more than usual while this uncertainty sorts itself out. This will take time, so we encourage investors to be thoughtful and deliberate before making material changes to their investments. We will notify you as our outlook evolves. In the meantime, we stand ready to help with your questions or concerns any time.

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[3] The "term premium" refers to the incremental yield available on longer term bonds relative to short-term bonds.
[4] The leading proponent of this economic construct is Horace W. Brock: [www.sedinc.com](http://www.sedinc.com)

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