Deducing the Culprits Behind the Recent Market Volatility

Hello volatility, our old friend.

By now, you've seen the headlines, full of scary-sounding words like *rout* and *storm*, *plunge* and *crash*. Whatever you want to call it, investors have certainly endured a rough time over the past few days. The Dow, dominating the media's coverage as usual, dropped more than 600 points on February 2, and almost *1,200* points on February 5.[1] That's a single-day decline of 4.6%, the largest since 2011.[1] The other major indexes were shaky, too.

It's been quite some time since we've seen volatility like this. The S&P 500 skyrocketed almost *20%* in 2017.[2] What was even more amazing last year was how calm and consistent the climb was. Since the election, any declines have been mere blips on the radar screen.

For investors who have grown accustomed to nothing but clear skies and calm seas, all these headlines might seem rather alarming. But in our experience, once you look at both *why* and *how* something works, it seems a lot less ominous. So let's examine the *why* and the *how* behind this new spate of volatility.

The Search for a Culprit

Pundits often treat volatility like a crime scene. "*Whodunnit?*" they want to know. This leads to a lot of finger pointing at various causes.

If you put all the suspects in a lineup, they would probably stretch out of the room. So let's focus on three of the most likely perpetrators.

The first two are all about our own economy.

"Wait a minute," you're probably saying, "I thought our economy was doing well." And you're right, it is. But here's a truth too many people ignore: *The economy and the markets are not the same thing*.

Here's what we mean. The economy has been growing slowly and steadily for almost a decade. Unemployment is currently at 4.1%, the lowest it's been since the turn of the century.[3] The labor market continues to add jobs almost every month. Best of all, there are signs that wages are finally beginning to grow at a faster pace, up 2.9% compared to this time last year.[3] This is all welcome news to workers the entire nation over.

For investors, though, this can create a bit of a dilemma. It might seem paradoxical, but sometimes good news for the economy isn't always good for the markets. In this case, so much of the markets' growth has been due to rising corporate profits. But a low unemployment rate means that in many industries, there are more jobs available than there are workers. That forces corporations to pay more to attract *and* retain talent. That, in turn, can cut into those aforementioned profits.

Even more important is what a stronger economy means for interest rates. Ever since the Great Recession, the Federal Reserve has worked to keep interest rates low. This helped to stimulate more borrowing and spending, which in turn helped the economy keep chugging along.

Only in the last two years has the Fed begun raising interest rates – and their pace can best be described as glacial. The reason for this is because the Fed didn't want to raise rates too fast and interrupt a tenuous economic recovery. But now, renewed economic strength has many believing that higher rates are here again.

When interest rates go up, the cost of borrowing increases. Companies and individuals both must pay

more to take out loans, which can lead to less spending. Should this happen, economic growth could begin to stall. Historically, low growth and high rates tend to lead to a dip in the stock market. ‘

Inflation Leaves Its Fingerprints

A related factor is the possibility of higher inflation.

Time for a little Economics 101. Inflation, to put it simply, is a “sustained increase in the general level of prices for goods and services.” Put practically, if it costs $1.50 to buy a candy bar when it previously costed only a dollar, you’ve likely got inflation.

Over the last ten years, inflation has remained very low - for many economists, almost mysteriously so, given how low interest rates have been. But now, there are signs inflation may be on the rise.

One reason for this is because wages are going up. This is known as **cost-push inflation**. When companies pay more in wages, they often raise prices on their goods and services in order to maintain their profit margin. As we’ve already covered, a sustained rise in prices is the very definition of inflation.

One of the tools the Fed uses to control inflation is higher interest rates. Because higher rates reduce borrowing, the supply of money circulating throughout the economy goes down. This, in turn, can lead to less spending on goods and services, thereby prompting corporations to lower their prices.

In short, if inflation goes up, interest rates will likely go up – and we’ve already discussed what higher interest rates could mean for the markets.

Whew! Got all that? Good, because there’s a caveat.

Back in December, Congress passed the largest tax reform in thirty years. A major part of that reform was a massive tax cut for businesses. Generally, when businesses pay *less* in taxes, they *don’t* raise their prices. But when they pay *more* in wages, they often *do* raise prices.

The question, then, is what will most corporations do with their tax cut? Will they use a big chunk of it to pay their workers more? If so, we may well see inflation go up. On the other hand, if corporations use their windfall on things like expansion and new technology, inflation may well stay steady.

Now, if you squint, you’ll probably see something important buried under all this: The recent volatility isn’t because interest rates have skyrocketed, or because inflation has gone up. It’s because they *might* go up.

“So what you’re saying, is that this volatility isn’t about what *has* happened, but about what *could* happen?”

Yes, that’s exactly what we’re saying. Welcome to the markets, where almost everything is based on future expectations rather than present realities. Which leads us to the final, and perhaps most important culprit:

The Butler Did It

Just kidding.

Volatility Has Returned Partly Because Investors *Expected* It to Return

For months now, analysts have been wondering how high is up.

"When will stock prices hit the ceiling?" they've been asking. "Aren't stocks going up too high, and too quickly? When will a new market correction occur? Aren't we overdue?"

You see, volatility is inevitable. Not just in the markets, but in life. It's *normal.* Far more normal, in fact, than what we saw last year. And because so many investors kept wondering when it would return, the moment new concerns arise – of inflation, higher interest rates, how to price in the new tax law, etc. – it's easy to think, "This is it! The correction is starting."

Remember, daily swings in the markets are usually driven by expectation and momentum. When some investors start to buy, a *lot* of investors often start to buy. And the same is true when investors start to sell.

So What Should We Do Now?

Quick story before we answer that.

Back in 1994, a 6.7-magnitude earthquake struck Los Angeles around 4:30am, knocking out power all over the city.

But not all the lights went out. For the first time in over a century, people looked up and saw thousands of twinkling objects in the sky…and a great, milky band stretching from horizon to horizon.

Then the 911 calls started.

"What *is* that?" people asked, worried. "Did the earthquake cause it?"

Of course, you can guess what it was: The Milky Way. For those who had spent their entire lives in the glow of the city, it was something new, something unexpected, something just a little bit scary. But in truth, it was there all along. People just couldn't see it.

Market volatility is similar, in a way. The factors that can cause volatility are always with us. Sometimes they're just hidden.

So what should we do now?

The answer is, *not overreact to something just because it's been awhile since we've seen it.*

It's quite possible that this is just a brief blip. As of this writing, the markets have already gone up and back down again this week. They may continue to do so throughout the year. Remember, the economy is strong, corporate profits are high, and taxes are low. The ingredients are there for continued growth. It wouldn't be a surprise.

On the other hand, investors may continue to feel jittery. Inflation *could* rise, and with it, interest rates. This may be the start of a larger pullback or correction.

That also wouldn't be a surprise.

Currently, we are still in the second longest bull market in history, but nothing lasts forever. Since we can't control what corporations will do, or what the Fed will do, or what the markets will do, we'll do what we've always done: focus on what we *can* control. We'll stick to our long-term investment strategy, and not react to market volatility as if a crime has been committed.

In the meantime, please know that we are here for you if you have any questions or concerns. We'll continue monitoring both the markets *and* the economy. If changing conditions require changes to our strategy, we'll let you know immediately.

As always, thank you for the continued trust you place in us. We appreciate you and your business. Have a great month!

Sincerely,

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