Market Update – Volatility Returns

Here are some observations given the tumultuous week in equities and the surge in volatility. If you recall, we pointed out in our last three quarterly commentaries (which are archived under our blog at www.stokescapitaladvisors.com) that volatility had dropped to levels that were abnormal and not sustainable. Indeed, we witnessed 15 consecutive positive monthly returns on the S&P 500 and logged 24 consecutive months without a 5% decline or more.

The low volatility backdrop, accommodative central bank policy, poor risk/reward characteristics in alternative investments like bonds, improving global economic data and the passage of President Trump's fiscal plan created a perfect ecosystem for a melt-up in stock prices. Even with the dramatic decline for the week, the returns for the S&P 500 are impressive from a historical perspective. Here is a summary as Thursday night's close:

Time Horizon	Cumulative Return	Annualized Return
1 Week	-8.5%	N/A
Year to Date	-3.3%	N/A
1 Year	14.7%	14.6%
3 Year	33.7%	10.1%
5 Year	88.7%	13.5%
10 Year	140.5%	9.2%

So, what has changed in the last week? Have we transitioned from a "melt-up" to a "melt-down" in equities? Is the almost decade old bull market in equities over? The explanation and answer to these questions is simple, yet also complex. Let me review the more obvious or fundamental answers to the resurgence in volatility first:

(1) **Improving Economic Data**: Last week we received more good news on the employment and wage front. These data will likely put pressure on the Federal Reserve to raise short term interest rates in the coming months and possibly faster than what markets had priced in.

(2) **Rising Bond Yields:** "Rising interest rates are negative for stocks……always". This is a quote from my economics professor at USC (Oliver G. Wood, 1987), yep still true. When you invest in a stock you are paying a premium or multiple for the future earnings and dividends. When interest rates rise, these future cash flows are discounted to lower present values.

(3) **Asset Valuations & Fed Speak**: It is not uncommon for Federal Reserve officials to comment on financial market conditions. Alan Greenspan famously cautioned investors in his "irrational exuberance" comment during the 1990's dotcom bubble. More recently, former Chair Janet Yellen and Greenspan both expressed concern over equity valuations and investors should recognize that the Central Bank is removing policy accommodation and attempting to normalize policy after a historic and decade long accommodative policy.

The above points are well documented on almost every financial news outlet and all are valid catalyst to the pickup in market volatility. However, the next discussion is somewhat difficult to explain but I think is a key driver to the dramatic swings in the market we witnessed last week.

Over the last several years, Wall Street created a brave, new asset class called Volatility. Yes, you can now speculate on the direction of volatility in the market 24/7. In 2008, these same investors (mostly hedge funds) found a way to bet against a portfolio of mortgage bonds called collateralized debt obligations or CDO's. But it was the creation of the credit default swap or CDS that really got the juice flowing in the hedge fund world. These derivative instruments allowed a fund to leverage their bet that the bonds in the CDO would decline in value and defaults would rise. You know the rest of the story, if not I highly recommend Michael Lewis' book The Big Short.

Fast forward 10 years later and here we go again, although the asset class is not the U.S. housing market. This time it is an obscure bundle of options contracts that provide an estimate of future market volatility, better known as the VIX. The CBOE Volatility Index or VIX is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, the VIX Index has been considered by many to be the world's premier barometer of investor sentiment and market volatility. Several investors expressed interest in trading instruments related to the market's expectation of future volatility, and so VX futures were introduced in 2004, and VIX options were introduced in 2006. The original intent for using such instruments was well intended and was used by portfolio managers as a hedging tool in traditional portfolios. But that was not enough for the fastmoving hedge fund world. They needed something more, so several exchange traded funds and exchange traded notes were created (UVXY, VXX, TVIX, SVXY) which allowed funds to take inverse and leverage bets on the direction of volatility.

I believe these investors got caught on the wrong side of this trade when the fundamentals mentioned above changed the outlook for volatility. Essentially, fund managers were making a bet that volatility would decline, and they could short the VIX and take long positions in stock futures. This trade was tremendously successful over that last two years and attracted billions of cash: The exposure could be as much as $1 trillion according to Bank of New York. The unwinding of this trade which started last Friday gave funds the weekend to prepare for an exit which started on Monday and continues. In order to unwind the losing trade, funds have to cover the short position by selling their long positions. The long positions are typically comprised of the stocks that you and I own which are being sold indiscriminately.

So here are the takeaways:

(1) The strong run up in equities was not sustainable and a pullback was expected.
(2) I don't believe this is the end of the bull market for equities.
(3) The U.S. economy is gathering momentum and see no evidence of recession.
(4) Company earnings remain on a growth trend for 2018.
(5) The Federal Reserve continues to raise short term rates but at a gradual pace.
(6) The VIX trade unwind will take some time to complete, expect more volatility in the days ahead.

As always, I appreciate your comments and invite discussion.
Regards,

Taylor T. Stokes, CFA
Managing Director
Stokes Capital Advisors, LLC