THE RETURN OF VOLATILITY

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Over the last week, a lot more has changed in the financial markets than in the real economy.

WHAT HAS HAPPENED?

Year-to-date gains in equities have been reversed, and a balanced portfolio has also slipped into a small negative return. Last week's sell-off accelerated into Friday, and this Monday saw a further decline of 4% in U.S. equity indices. The media has put a spotlight on this situation – one headline Monday night was "Dow plunges 1,175 points, biggest drop in history." A 4% drop in equities is certainly noteworthy, but not historic.

Over the last couple of months, interest rates and inflation expectations have been slowly moving upward and equity markets have taken it in stride. However, last Friday's U.S. jobs report appears to be a catalyst for the sell-off. Wage growth for January was reported at 2.9%, as compared to the recent trend of 2.5%. Importantly, the prior two month wage gains were also revised up – so wages have been rising for three months in a row. This raises questions in investors' minds about the outlook for inflation and the Fed's reaction.

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WHAT DO WE THINK ABOUT IT?

The title of last month's *Perspective* piece was "Repercussions" – a reference to the potential of the improving global growth outlook leading to a jump in inflation. We have been sanguine about the longer-term outlook for inflation, while acknowledging the potential for a cyclical bump. Fixed income markets have been gradually pricing in the possibility of a bump, as the 10-year Treasury Inflation Protected Securities (TIPS) breakeven has risen from a low of 1.67% in June to 2.09% today. We have also moved from a position two months ago where investors were worried about the potential of a yield curve inversion (long-term rates falling below short-term rates) to concerns about a steepening yield curve. The steepening yield curve actually makes the Fed's job easier, and markets are now discounting three rate hikes over the next year. This is what the Fed hopes to accomplish as it would allow them to raise rates, in line with market expectations.

The rapidity of the market decline in recent days is meaningful, but the exact causes are indeterminate. The price action in equities seems to indicate a significant role of computer-based traders. The accelerated declines in the last two hours of trading on Monday have the footprints of trend-following algorithms as opposed to fundamental investors. Credit markets – an excellent barometer on deteriorating economic and financial conditions – have held up well and are not showing signs of stress. The banking system has also increased its capital from $500 billion in 2000 to $1.25 trillion, significantly reducing its vulnerability to market stresses.

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WHAT SHOULD BE DONE?

We have been highlighting that equity markets had gone 80 weeks without a 5% correction (as opposed to the normal frequency of 10 weeks) – so a correction was long overdue. Fortuitously, we have our monthly investment strategy meetings this week and will conclude our deliberations on Thursday.

We have benefitted for years from a disciplined approach to asset allocation, and we expect this discipline to pay off going forward. We have been constructive on risk-taking for quite some time and will debate whether the fundamental picture is really changing meaningfully. We look forward to updating you on our views.