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When Volatility Comes Knocking

From January 29th to February 8th, the market experienced its first 10% correction since February 2016. Following the market performance of 20% appreciation in 2017 and 5.6% in January 2018 alone, this quick pullback has led to uncertainty as to what comes next and a spike in volatility.

The word "volatility" in the financial press is normally perceived as a *scary* phrase, but it is *not necessarily* something to be feared. Volatility is simply the dispersion of prices within a given time period. When stock prices have been steadily increasing, a sudden decline in price means that the trend of prices or the *dispersion of prices* has changed. The common indicator used, the "VIX Index," is a derivative of this movement. So, what changes the trend and increases price dispersion? Sometimes, it's uncertainty or new concerns but, in this instance, change is the dominant factor.

Change is occurring in the Federal Reserve policy, fiscal spending, GDP growth, actual inflation, and expected future inflation. Through quantitative easing, the Federal Reserve has provided liquidity to financial markets for eight years that is now beginning to be paired back. This, in turn, has led to a recent handoff to fiscal spending in Washington, which can lead to increased deficit spending. The amount or size of this spending will impact future outcomes and is part of the reason for the recent price action as the market digests all of this. As mentioned in the previous Bull and Bear, real GDP growth has been moderating around 2% for almost a decade and has now finally been near 3% for a few quarters. For businesses and employees that have not participated in the extraordinary growth of the most innovative sectors, it is great news that the tides may finally be turning to include more industries within the economy. Along with nominal growth though, inflation has started to increase as well. Inflation, being a broad and sustained increase in the price of goods and services, has been exceptionally low for the past few years and is now moving higher alongside growth. This has certainly had some impact on the bond market and recently real asset prices. Market participants are assessing whether or not this reflation remains positive or if it will turn into something that needs to be addressed via faster, tighter financial conditions.

Volatility is a normal occurrence that we can embrace and recognize that the financial landscape is changing. A correction lets the market pause, catch its breath and reassess its trajectory. With the Federal Reserve slowly removing itself from the market, market participants will have a more pronounced impact on the pricing, potentially leading to more volatility. With GDP picking up speed, sector rotations may continue to change as investors continue to seek new growth opportunities. The bull and the bear will continue to fight over where this growth can be found and where opportunities will present themselves to those who are nimble and are accepting of change.

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