ASPIRIANT

MARKET PERSPECTIVE

MARKET VOLATILITY RETURNS

What does this mean for you?

Key Points

- U.S. markets experienced a price decline of roughly 8% over the past six business days through Monday, before recovering 1.7% yesterday. The drops were particularly severe last Friday and Monday with the S&P 500 Index losing 2.1% and 4.1%, respectively.
- When market valuations are stretched, any mildly unexpected or disappointing data tends to be treated with much less patience by investors. In this case, a combination of extended market valuations and recent data on rising inflation pressures triggered investor anxiety about more rate increases from the Federal Reserve.
- Our portfolios are designed to embody roughly 75% to 85% of the total market risk of their respective index benchmarks. So, on average, we would expect to capture roughly that same percentage of drawdown. Please keep in mind this is an average expectation over longer periods of time, not a precise prediction of how the portfolios will perform in all environments.

What is happening?

Markets, as measured by the S&P 500 Index, experienced a price decline of roughly 8% over the past six business days through Monday, before recovering 1.7% yesterday. The drops were particularly severe last Friday and Monday with the index losing 2.1% and 4.1%, respectively. Markets remained volatile today, although they showed some signs of stabilizing.

While it’s often difficult to identify the precise cause of market movements, we generally attribute the recent volatility to some data on rising inflation pressures highlighted in last Friday’s January employment report. Specifically, the market’s retreat came from a higher than expected wage gain (e.g. +2.9% year-over-year), which might prompt the Fed to normalize interest rates at a quicker pace. Investors fear interest rates rising faster than anticipated won’t be received kindly by an extended equity market whose advances have been heavily supported by low interest rates since the Global Financial Crisis.

In our view, while we are seeing some rising inflation pressures due to an improving economy, we are rising from a very low base. Specifically, core Personal Consumption Expenditures (PCE) inflation has rarely been above 2% for much of the past two decades, mostly due to larger structural forces that are fundamentally deflationary in nature. Deflationary forces like globalization, technological disruption and demographics aren’t expected to change anytime soon. So, while there is room for inflation to move higher to a more acceptable range, we generally place a low probability on any kind of damaging high-inflation scenario.

It’s also important to note that when market valuations are this demanding, any mildly unexpected or disappointing data tends to be received with much less patience by investors. This behavior was evidenced by the stronger follow-through selling that occurred Monday.

Should I be concerned?

No, for several reasons. First, we’ve been expecting higher volatility, and this assumption has been a key consideration influencing our investment strategy. Second, despite the relatively one-sided market appreciation we’ve been fortunate to experience over the last two years, risk is always lurking and was overdue to show itself. To that end, we should experience a 5% loss in the equity markets about once every 90 days. But prior to yesterday’s drop, the streak was near 400 days!

When you throw in sensational headlines such as “the largest point drop ever” or “market meltdown,” it helps to have some perspective that in percentage terms, the declines, while meaningful, are not at all unusual for long-term equity investors.

Are we making any changes?

While larger market movements may influence our longer-term forecasts, they don’t always. In this case, we don’t expect to make any changes at this time to our investment strategy because we think our portfolios are already well prepared with meaningful allocations to fixed income, defensive strategies and defensive equity, which all help reduce the effects of volatility.

What effect will this have on my portfolio?

Given that our current portfolios are designed to embody roughly 75% to 85% of the total risk exposure of their respective benchmarks, on average we would expect to capture roughly that same percentage of drawdown. So, if one of our benchmarks drops 10%, we would expect our portfolios to decline roughly 7.5% to 8.5%. That said, it's important to bear in mind this is an average expectation over longer periods of time. It should not be interpreted to mean our portfolios will perform that way in all environments and over intra-day or daily time periods. However, as a longer-term average expectation, we think this is a fair estimate of our relative performance.

Sincerely,

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Important disclosures:

Past performance is no guarantee of future performance. All investments can lose value. Indices are unmanaged and you cannot invest directly in an index. The volatility of any index may be materially different than that of a model.

The S&P 500 is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity and industry.

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