MARKET STRATEGY VIEWPOINT

Elastic Snapped

February 9, 2018

Volatility Anomaly Sunsets

The long overdue correction is upon us. What are the drivers and what do we do next?

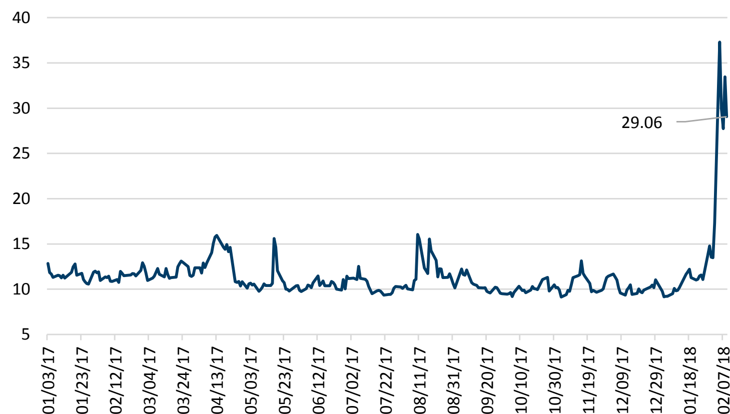
It's never different this time. Not when it comes to financial markets. Reversion to the mean is relentless and equity valuations and equity volatility eventually find a middle-ground over time. Timing the call for the inevitable turn toward normalcy, or the onset of a market correction remains the holy grail. Those that call it exactly are lucky. Those that expect it are adept at sidestepping emotion and applying seasoned common sense. It's simple and difficult simultaneously.

The rally of 2016-2017 and January 2018 is similar to past occasions when valuations were stretched and volatility was abnormally low. Such divergence from the mean can last for only so-long until the elastic eventually snaps. This time it seems the elastic is reverberating harder than most, yet the recent action is likely just some reversion (see a pattern here?) from the smooth ride markets enjoyed in 2017. Said another way: the bigger they are, in terms of market rallies, the harder they seem to fall. Notice we have not yet cited one piece of data in our attempt to explain the market's move. None is really needed, although there are indeed numbers to which we will point. Momentum (stocks up, volatility down) finally waned as its always does. In terms of the correction, we were overdue.

The VIX Index closed at 29.06 on Feb 9. A record low in the VIX was reached in November of last year.

Figure 1: CBOE S&P 500 Volatility (VIX) Index

Source: Bloomberg



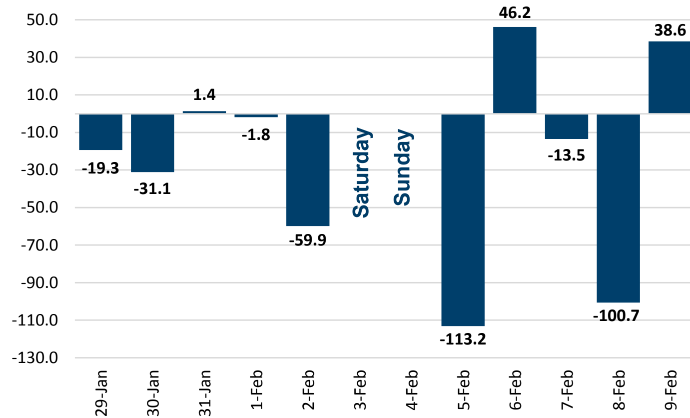
Volatility Index Averages -ended December 2017

2017	5-Year	10-Year
11.1	**14.1**	**20.1**

FC Wealth Solutions (FCWS) is an independent advisory firm that places clients' interests first. AT FCWS we provide customized portfolio management and financial advice in a clear and cost-effective manner.. Our distinctive allocation methodology emphasizes participating in up markets while protecting capital against sustained asset price declines.

Figure 2: S&P 500 Index - Daily Point Moves

Source: Bloomberg



The S&P 500 Index has fallen by 8.7% over the last two weeks. The index was down 10.1% at the current year-to-date closing low on Feb 8.

For those following along, you have noticed our suspicion over the longevity of the equity rally. In fact, the recorded 15 straight months of S&P 500 Index gains, through January, was indeed unprecedented in the history of capital markets. We warned that each successive, positive month increased the odds for a material correction and risked exacerbating the downside violence. Now that the event is upon us what do we expect and what should we do? We believe the extent of the rally could leave a 10%-15% correction in its wake when it is over. It could be more severe, however we do believe there is an undercurrent of positive fundamentals that will cause the drawdown to eventually be bought. We do not believe current market action foretells a definitive and sustained rollover in stocks, as we still believe the equity market finishes higher for the year (S&P down 2% at this writing). We are on record with an expectation for an approximate 7% gain in the S&P 500, and we continue to believe that number is attainable. Importantly, this forecast was colored by the realization that volatility would be higher and stocks would not go up in a straight line.

The equity market ran out of steam when valuations become over-extended and successive monthly gains reached beyond previous extremes.

Although calling a drawdown's timing is very difficult, such extreme conditions can signal a market rally's approaching end.

Behind The Numbers

Here is where we get into the data. Very simply, one key reason for the current drawdown...equity valuations had gotten extended. The forward P/E multiple had reached highs of 20.1x; fell to 18.7x based on the improvement in post-tax-plan earnings forecasts; and due to the drawdown, has settled at 16.8x so far. The 20.2x and 18.7x readings were clearly too high compared to the 10-year average (15.6x) and the 10-year median (15.4x). The market had become too rich and it stayed that way for an extended period (typical for patterns of emerging euphoria). This data, among other statistics, helped lead us to the conclusion that an equity correction was only a matter of time.

While we label the correction as justified, there is clearly enough fundamental evidence to remain constructive on equities through the

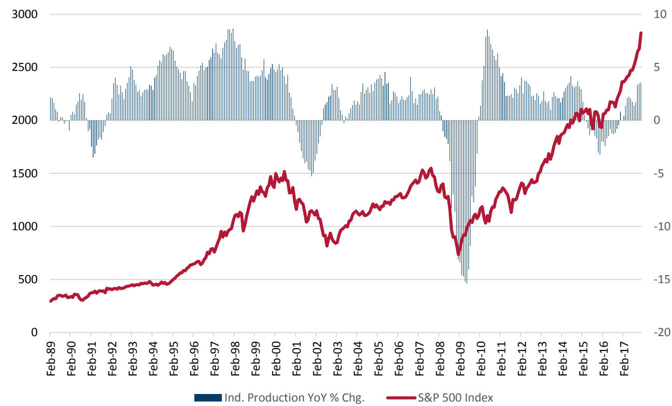
We estimate the revitalization in business and consumer activity will be supported by the new U.S. tax policy and the likelihood synchronized global growth will continue.

balance of 2018. Most economic data points we monitor continue to show a solid economic foundation under this market. Here are some.

Historically, the direction of U.S. Industrial Production has proved be a key tool in forecasting a change in the overall economy.

Figure 3: U.S. Industrial Production YoY % Chg. Vs. S&P 500 Index

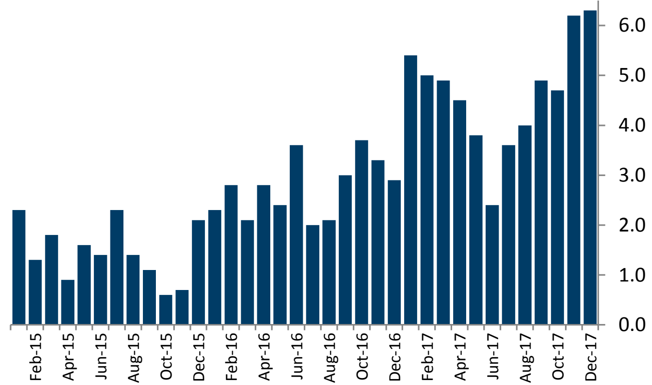
Source: Federal Reserve; Bloomberg



U.S. retail sales have not been this strong in six years.

Figure 4: U.S. Retail Sales ex Autos YoY % Chg,

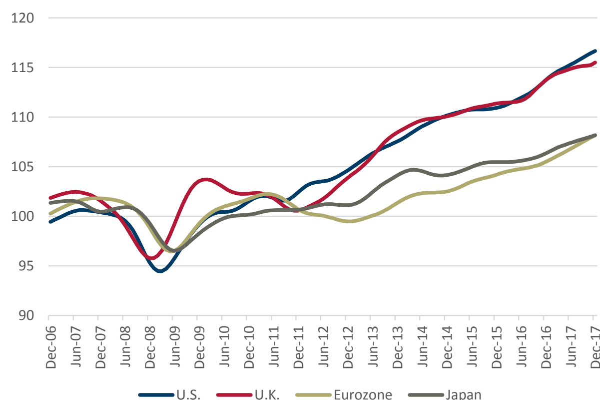
Source: U.S. Census Bureau



The comprehensive leading indicator index shows no signs of turning lower.

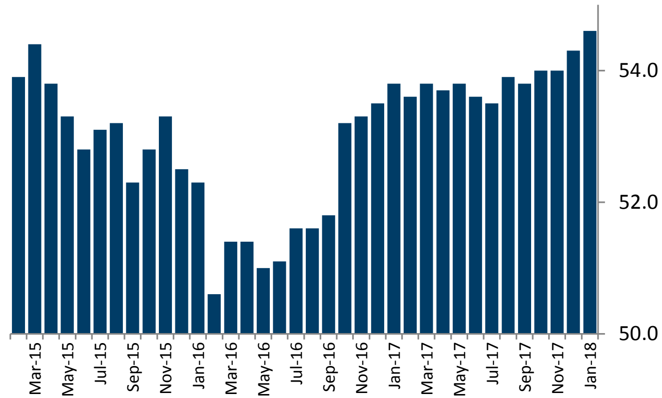
Figure 5: OECD Leading Economic Indicators

Source: Organization for Economic Cooperation and Development



The JP Morgan Global Composite illustrates activity in both the services and manufacturing sectors of the global economy.

Figure 6: JP Morgan Global Composite PMI Index
Source: JP Morgan; Bloomberg



The charts depicted illustrate the economic strength still-present, and we do not expect conditions to sustainably deteriorate through 2018. The primary risk to this view is higher than expected inflation that may cause central banks to tighten policy more than expected. Notably this is not our base case as inflation indicators, while ticking a bit higher recently, have not shown a trend change. We believe structural forces on inflation may persist in keeping a lid on prices, despite the recent fears. And while we anticipate interest rates will be higher in 2018, the 45 basis point rise we have witnessed in the 10-year Treasury may be a bit overdone in the short-term (2.85% today).

The market activity we have seen lately is consistent with a business cycle expansion that may be in its latter innings. We have indicated the new tax plan has elongated this cycle , but watching its evolution will be key in setting expectations for market returns. At this stage we often see earnings multiple contraction and an equity market that moves more in tune with fundamentals. This leads us to expect less robust equity returns in 2018 and 2019.

What To Do Next?

We believe accumulating stock during the course of this drawdown is a prudent strategy given the current fundamental conditions.

Fundamental underpinnings and the position of the business cycle tells us that there is room for positive equity returns. As a result, investors may seek to accumulate equity positions by systematically investing during the periodic price weakness. However, now is the time to ensure that portfolio risk is contained and cyclical/defensive positioning is well balanced. Equities are to be over-weighted, relative to bonds, but only modestly. Alternative exposures, with low correlations to both equities and bonds, should be an increasing consideration as potential asset class returns decrease and volatility rises.

Questions?

Please contact us should you need further detail on this analysis and/or our general market view. We will be glad to have a discussion as to how these and other circumstances may effect your asset allocation or portfolio strategy.

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This commentary has been prepared for FC Wealth Solutions by Bower Hill Capital Management LLC, a registered investment adviser in the Commonwealth of Pennsylvania.

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