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COMMENTARY

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Volatility is Back

Stocks have entered another bout of volatility following two months of calmness. The S&P 500 had a stretch of 36 straight trading days without closing up or down more than 1% prior to Wednesday's 1.08% decline. More volatility followed on Thursday and Friday, as declines were widespread in stocks, and bonds rallied. The 10-year Treasury has plummeted below 1.85% for the first time since 2016. Volatility is back for three primary reasons:

> ***The Fed.*** The market sell-off started after the Federal Reserve announced their decision to cut interest rates by only 0.25%. Investors were hoping for a 0.50% cut and hints for further cuts from the Fed through year-end. However, the Fed's statement was not as dovish as market participants wanted and it looks like they will maintain their data-dependent approach, which could result in no additional cuts barring a sharp downturn in the economy. Markets don't like uncertainty, but that is what they are getting when there is uncertainty in what the Fed will do next.
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> ***Trade War.*** President Trump's frustration with the lack of progress being made in trade negotiations prompted him to announce an end to the trade truce with China on September 1. This turn in trade negotiations caused equity markets around the world to fall, while safe-haven assets like gold and bonds rallied. A lingering trade war can disrupt global supply chains and has potential to slow economic growth further.
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> ***Softer Economic Data.*** We are in a record-long economic expansion and there are signs of fatigue. Weaker economic data is also driving market volatility and is a big reason for the downward trend in bond yields in recent months. The pace of manufacturing growth in the U.S. has dropped to its slowest pace since 2016 while global manufacturing is contracting. Industrial production growth is also slowing, and housing activity remains tepid despite a sharp decline in mortgage rates. The labor market remains solid, but the pace of jobs growth has been in a downtrend this year.

Putting It All Together. The net effect of the Fed lowering interest rates, trade war, and slower economic growth is complicated and intertwined. The Fed lowering rates may have given President Trump more leeway to take a harder stance on China and the softer economic data gives the Fed more leeway to lower interest rates. Bad news can easily equate to good news as the push and pull of these factors take effect. We anticipated increased equity volatility in the second half of this year for quite a while and we are starting to see this play out. While volatility is picking up, we offer some positives to keep in mind. Consumer spending, which makes up much of the U.S. economy, remains strong as the unemployment rate remains near a 50-year low. Interest rates are still relatively low and the Fed seems to be fairly accommodative. We also note that the current corporate earnings season is better than expected. Volatility has been abnormally subdued most of the year, so as it picks up to normal levels it may feel like a lot.

Game Plan. We are in the longest bull market and economic expansion in U.S. history. Volatility is typical in the later stages of a bull market. With the conversion of Fed uncertainty, an escalating trade war, and softer economic data, it is prudent to mitigate portfolio risk. As a way to mitigate risk, we recommend rebalancing client portfolios to their long-term risk objectives, diversifying equity risk (with the inclusion of alternatives), and managing credit risk within fixed income.

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Glossary

The **S&P 500 is an index** of 500 stocks chosen for market size, liquidity and industry grouping (among other factors) designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe.

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