

FROM THE DESK OF THE CIO

Volatility in Context

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As rough as the equity market waters have been to navigate, we remain encouraged by the ability to generate relative value, reasons behind which we explore in this piece.

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The fourth quarter is shaping up to be a mini identity crisis for the domestic equity markets, as it figures out whether to conclude the year in the red or black. Influences of its fluctuations continue to stack up, spanning geopolitics, trade, commodity pricing, and central banking influences, to name a few, while algorithmic participants quickly pounce on any news that possibly portends an impending downturn (looking squarely at you, yield curve slope!). As rough as these waters have been to navigate, we remain encouraged by the ability to generate relative value, reasons behind which we will discuss momentarily. But first, a quick sidebar on the exercise of sorting through macroeconomic news-flow noise.

Portfolio managers tend to have biases for the sources of inputs that impact their investment decisions, with a wide array of opinions on the utility of a macro viewpoint. Some devise and manage strategies that attempt to predict the economic cycle, while others focus on bottom-up fundamental merits and dismiss top-down efforts as distractions. The natural tendency is to stick with what you know and what has worked. The problem with this approach is that by focusing solely on inputs to your analyses that have worked over a period of time, you miss inflections derived from the periphery. We believe that an assessment of the macro backdrop is one important tool among a host of many others that can make our analysis more robust.

Back to news of late: We see recent market price swings as signs of it wrestling with two primary factors:

- 1) Central bank policies pertaining to interest rates, and
- 2) Tariff escalations.

We unpack both in the context of price reaction we're seeing.

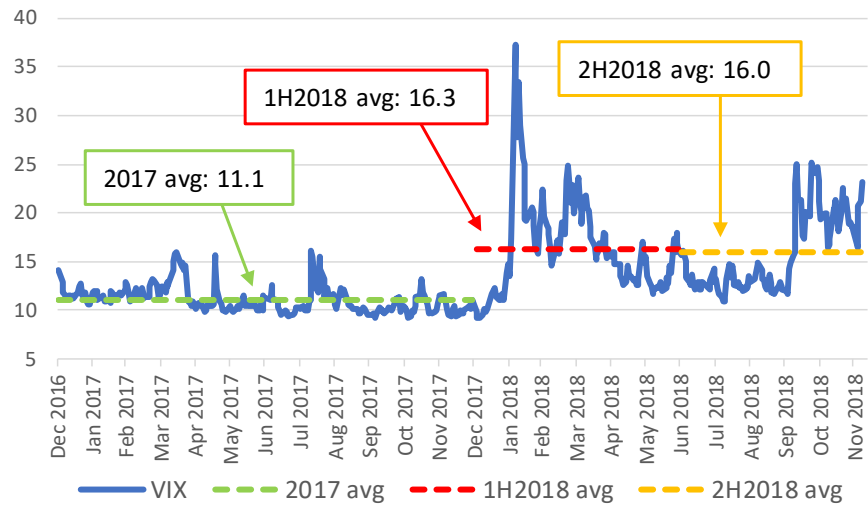
Market Reaction

Enduring a 10% peak-to-trough drawdown in the fourth quarter makes for an unsettling way to close out the year. As queasy as the short term fluctuations are, it's important to keep the volatility in context. Quite simply, 2017 was an incredibly muted year, volatility wise. This, in turn, causes the spike we saw this past January to stand out as an outlier relative to all of last year and makes its recent reemergence since October unnerving (*see chart 1*). However, looking back across the prior volatility environment since the financial crisis, specifically via the CBOE

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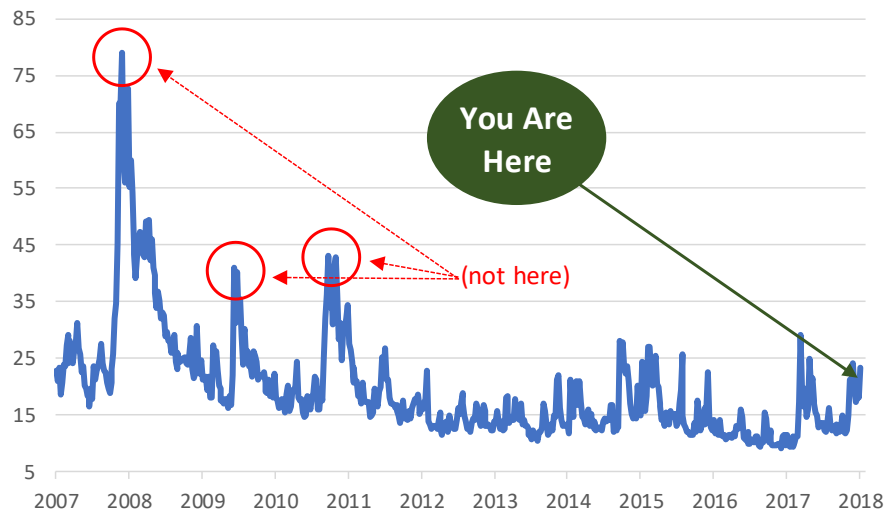
Market Volatility Index ("VIX"), we find ourselves well below high-water marks of the calendar years 2008 through 2012 (see chart 2).

Chart 1: CBOE Volatility Index ("VIX"), 2017 vs 2018



Source: FactSet. 2H2018 through 12/14/2018.

Chart 2: The VIX since the Financial Crisis



Source: FactSet.

We've thus far seen 13 trading days where the market has closed down more than 2%, versus none across the entirety of 2017. And while the number of such declines in 2018 is also higher than those seen in 2015 or 2016, we are a far cry from the 41 and 28 we saw in 2008 and 2009, respectively.

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Rates

Given that we've grown accustomed to near-zero deposit yields on our savings ac-

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counts, it takes a little cobweb dusting to devise a game plan with Fed funds rate now back above 2% for the first time since Sep 2008. Monetary policy traditionally falls into the inflation-management side of the Fed's dual mandate--its other responsibility being maximum sustainable employment--and the notion of an increasing short-end of the yield curve almost seems foreign. Therefore, it's easy to overlook what a near-zero short-end truly signals. The Fed, with limitless access to every driver to economic output, had concluded that our recovery out of the financial crisis was so precarious – largely due to the need to shore up bank capital reserves – that it kept the overnight rate near-zero for nearly seven years. After a series of gradual increases across the past three years, we are now at a level that signifies that the economy is largely healthy enough to stand on its own, hence Chairman Powell's dropping of "accommodative" rhetoric in the September FOMC meeting statement.

For maturities extending farther out on the yield curve, impacts here are less driven by the voting convenience of an FOMC meeting and more by market dynamics. Given the pool of constituents in the latter exponentially dwarfs the former, timing disconnects between the two can have dramatic impacts on the interim shape of the yield curve. The difference in their mechanics also can cause conclusions drawn from one day's observation to differ materially from those spanning a broader time period. We believe this describes the reason for the return of the curve-flattening harbingers, who took the summer off and recently reemerged once the 5-year temporarily inverted relative to the 2-year. That being said, this analysis is extremely dynamic and merits close monitoring, given the predictive power that flat/inverted yield curves provide. So far we don't believe we have evidence to merit capitulation on our thesis for further, albeit long-toothed, economic expansion.

In terms of the implications for higher rates on the economic engine of our economy, a closer look reveals that US corporations are in much better shape balance sheet health-wise than they were a decade ago. We've previously taken a look at bank balance sheet health [here](#), but in terms of the constituents forming the broader S&P 500, we see a lot more cash offsetting total debt levels on a relative basis (see chart 3). For example, net debt as a percentage of the aggregate market cap that it supports is currently 21.1%. This figure was over 3x higher back in December 2007 at 65.2%.

Chart 3: S&P 500 Net Debt Relative to Market Cap (\$ in billions)

	<u>Dec 2007</u>	<u>Sep 2018</u>
Cash & Short-term Invest.	\$1,539	\$2,489
Total Debt	\$10,090	\$8,126
Net Debt	\$8,551	\$5,637
Tot Market Cap.	\$13,119	\$26,659
Net Debt/Market Cap.	65.2%	21.1%

Drastically different leverage scenarios

Source: FactSet, company filings.



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Considering the ~\$600 billion of output growth expected from our \$20 trillion economy for next year, Chinese tariffs would represent an approximate 15% impairment to the expected dollar growth.

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Tariffs

From a securities analysis perspective, any additional expenses that have zero probability of enhancing the returns of said asset will impair its value. Tariffs are no different, especially for economies heavily reliant upon services rather than manufacturing. The goods we import to support consumption simply come at a higher price tag once import taxes get passed onto the consumer. In terms of a bargaining pawn in the "great" effort to strike a better deal, only time will tell whether the downside risk exposure makes the eventual upside worthwhile. Since the "Tariff Man" leading these efforts is a politician who will likely seek reelection, we still believe that odds are higher for a favorable resolution than the risk that we head into a trade war tailspin. But, the market detests uncertainty, and forecasting actions of our deal-maker-in-chief has proven difficult.

To put the China tariff magnitude in context, the incremental \$200 billion of Chinese imports, along with a threatened \$267 billion of additional goods to be taxed, would siphon off \$93 billion from economic output, assuming a 20% hike that's fully collectible. Considering the ~\$600 billion of output growth expected from our \$20 trillion economy for next year, this represents around 15% impairment to the expected dollar growth. Again, this is under a worst-case scenario based upon known variables. However, coming out of G20 meetings, probability weighting of that outcome appears to be declining. All of this merits close monitoring of developments with our relationship with Beijing, but so far we don't have a signal to take our risk allocation off the table.

Conclusion

Short-term market volatility can make for a frustrating experience along the quest for long-term returns. Although we lack precise tools that can detect directionality on any given day, especially in light of the dynamic impacts of late, we believe that assessing whether the cylinders to our economic engine are still firing is a better exercise to assist with risk allocation decisions. In isolation, higher rates and tariffs are impediments to economic growth. In the broader context of challenges the market has endured over time, the current set of headwinds don't present insurmountable challenges. However, since downside risks are not off the table, all of these dynamics merit close monitoring, which we will continue to do in light of our fundamental management investment process.

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About the Author

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Mike joined SWS in 2017 as its CIO and leads portfolio management, risk management and research for the firm. Before joining SWS, Mike was a portfolio manager on \$4 billion of long-only equity portfolios at the Ohio Public Employees Retirement System (OPERS). He leverages over sixteen years of experience on both the buy-side and the sell-side to bring an institutional research and portfolio management framework for SWS investors today.

Prior to OPERS Mike was responsible for investment bank equity research at FBR Capital Markets. He received his Bachelor of Science in Economics, Finance concentration, from the Wharton School at the University of Pennsylvania and is a CFA® charterholder.

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