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MARKET VOLATILITY RETURNS

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Earlier this week SpaceX successfully launched its Falcon Heavy rocket from Cape Canaveral. Tucked neatly in its nose was one of the greatest PR stunts in recent history – Elon Musk's personal Tesla Roadster. We were all treated to almost surreal images of the convertible, piloted by a dummy in a spacesuit, floating in front of the Earth. On the dashboard mounted screen was a simple message – "*Don't Panic!*"

The message was a nod to Musk's favorite childhood book *"A Hitchhiker's Guide to the Galaxy"* – but set against the more terrestrial backdrop of a wild week in the market, the symbolism should not be lost. Like SpaceX, the market has recently been flying higher and faster over the past year, into uncharted territory. While the gyrations have been meaningful, especially after a period of uncharacteristic tranquility, the moves are not surprising nor are they cause to panic.

There are theories abound as to the reason for the steep declines. The mood of the market began to turn last week when Health Care stocks declined on the news that Amazon, Chase and Warren Buffet were partnering to disrupt healthcare. That sentiment carried through to the routs on Friday, Monday and Thursday which eliminated all of January's remaining gains.

Many have argued that a stronger than expected jobs report was the epicenter of the market decline. A closer evaluation, however, shows that the jobs report may not have actually been stronger than expected. First, while the job gains of 200,000 were higher than the 175,000 forecast, monthly job gains for November and December were revised downward by 24,000 rendering the forecast of 175,000 accurate. Second, a more careful evaluation of the purported wage gains, shows that they may appear stronger than they actually were. Due to weather issues, more workers logged part time hours than they normally do. As a result, the average workweek declined and the average wage over that period increased, giving the perception of stronger than expected wage gains.

The market's main concern is that wage inflation will cause the Federal Reserve to raise interest rates faster than anticipated, negatively impacting economic growth and corporate profitability. While there is a possibility this can happen, and it is one of the primary risks we addressed entering this year, neither the jobs report nor the other indicators cited for the recent decline have caused us to increase our level of concern.

Rather, we believe this was a market searching for a reason to sell. A white hot start to 2018, nonexistent volatility since early 2016, and stretched equity valuations left the market susceptible to a sell off. The voracity of the selloff has been magnified by programmatic trading strategies which seek to reduce risk as volatility increases. This, in turn, creates more volatility resulting in a negative loop. Further adding to the volatility are untested investment products and strategies which fail in a stressed market environment. While this volatility is uncomfortable, we believe this correction to be healthy, allowing the market to reinforce its foundation.

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From a fundamental perspective, we believe the market and the economy are on solid ground. Global growth is strong and we expect it to further accelerate this year. Corporate profits have been robust. With 70% of S&P 500 companies having reported fourth quarter results, Earnings per Share growth has increased 15% while revenue growth has increased 7%. Organic growth, coupled with the tailwind created by lower corporate tax rates, are likely to add to these growth rates in 2018.

Interestingly, credit spreads tightened during the market declines early in the week prompting the Wall Street Journal to pen an article titled *"Credit Markets to Stock Investors: Calm Down"*. Normally, credit spreads widen during market declines as investors demand more return during periods of market stress.

We believe the current market declines are temporary; however, the unwinding of leverage in the market and the failing of untested products and strategies could result in steeper declines. Leverage adds fuel on the way up and the way down. Prospectively, we do not believe the market will resume its meteoric rise. Risks associated with a late stage economic recovery, combined with frothy valuations are likely to result in lower returns prospectively along with increased volatility.

We do not advocate making radical portfolio changes in anticipation of, or in reaction to, major market moves. It is impossible to accurately forecast the future on a consistent basis. Notwithstanding the foregoing, we are evaluating several portfolio adjustments which will be implemented at the appropriate time. These include, but are not limited to:

- *An increase in the weighting to fundamentally driven investment strategies at the expense of market driven strategies.*
- *An increase in the allocation to hedged solutions.*
- *An increase in the allocation to non US equities.*
- *An increase in the allocation to bond strategies that hedge against rising interest rates.*

While we cannot control the direction of the wind, we can adjust our sails to best position ourselves for the journey ahead.

We will continue to monitor the volatility closely and keep you informed of any necessary changes. As always, please contact us with any questions.

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