The Cobblestone Advisor

Investment Brief

April 23, 2018

COBBLESTONE
CAPITAL ADVISORS

The Return of Volatility

After a strong January to start 2018, the stock market stumbled in February and March to finish the first quarter slightly negative (-0.8% for the S&P 500). Developed international stocks fared a bit worse (-1.5%), while emerging market stocks managed to post positive returns for the quarter (+1.4%). Unfortunately for investors, bond markets provided no safe harbor as a spike in interest rates led to a -1.5% return for the Barclays Aggregate Bond Index.

However, the biggest story of the quarter was the return of volatility. A consistent theme of our communications to clients since the days immediately following the 2016 Presidential election has been the startling lack of significant price fluctuation in stocks. From November 2016 through January 2018, a surreal and abnormal calm settled over the market. Stronger than expected economic data, broad-based optimism, and robust corporate earnings pushed stock prices consistently higher, while any signs of softness were generally ignored. The S&P 500 posted a record 15 consecutive months of positive returns and went over 300 days without so much as a 3% pullback.

Although enjoyable, unsurprisingly, it didn't last. In our first quarter *Cobblestone Advisor*, published on January 23, 2018, we advised that the "recent lack of volatility seems to be increasingly unsustainable." Though the timing of the statement owed a fair amount to luck—in truth we had been expressing similarly cautious statements for a while prior to that point—the markets did indeed top out very shortly thereafter. Since closing at an all-time high on January 26th, the stock market has been on a relative roller coaster ride, plunging almost 12% in just two weeks before mounting a couple of failed rallies and generally just gyrating around wildly for almost three months.

While perhaps not entirely unexpected, this change in the tone of market activity can be quite unsettling for investors. With that in mind, we think some perspective may be useful.

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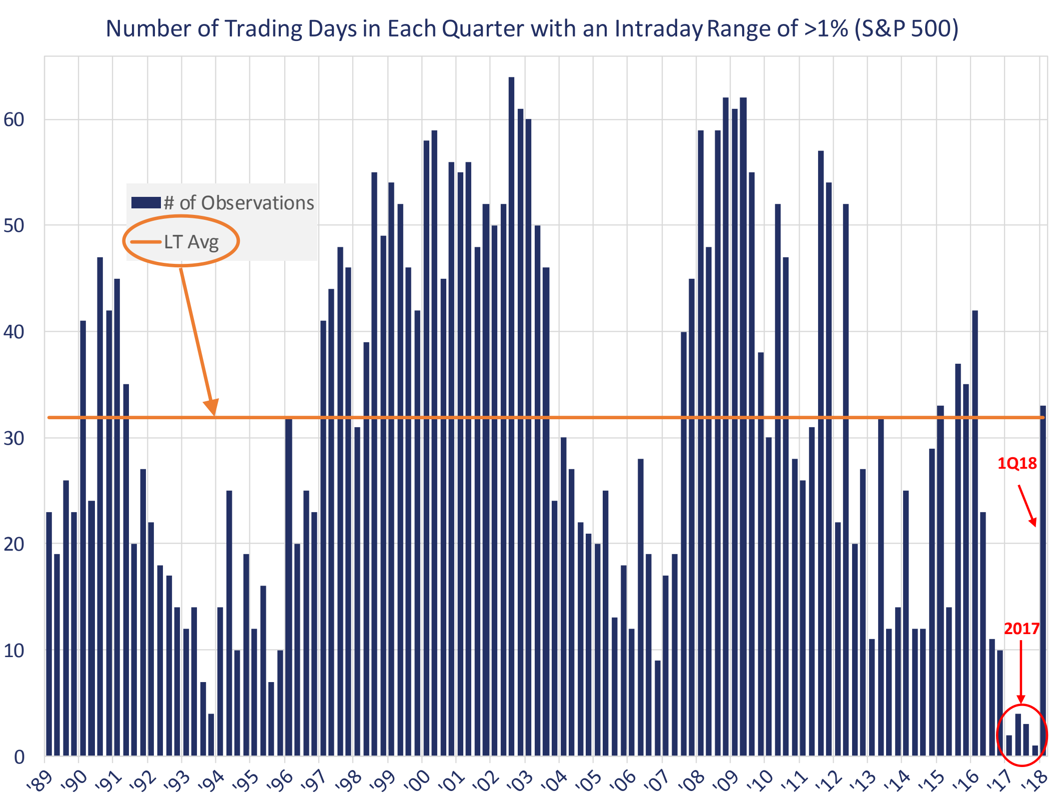

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First, while the recent volatility may feel extreme relative to the preceding quarters, it is actually a lot closer to the historical average experience. This is illustrated by the chart on the previous page, which measures the number of days per quarter in which the S&P 500 moved greater than 1% in either direction. At least by this measure, recent market movements are a lot closer to normal than those of previous quarters.

Second, the stock market is still up more than 20% since the beginning of 2016. This is largely a reflection of the strength of the U.S. economy over that time. Importantly, we do not see any substantive changes in the macro-economic landscape in recent months. Corporate earnings, employment, leading indicators, and confidence levels continue to be quite healthy and are more than offsetting the normal late-cycle headwinds that are starting to emerge.

Yet clearly something has changed and it's fair to wonder what that might be. We are always cautious about offering overly simplified explanations regarding the causality of market movements, but it appears that the market is primarily reacting to a couple of things.

The first is inflation and interest rates. Certain measures of inflation came in higher for the quarter, such as the larger than expected increase in reported average hourly earnings that exacerbated the first round of selling in February. The Federal Reserve also increased the Fed Funds rate at the March meeting and seems intent on raising rates another two or three times this year. Not surprisingly, interest rates rose sharply across the curve in the first quarter.

More recently, fears regarding escalating trade tensions have roiled the markets. While the impacts of President Trump's announced tariffs on China and China's retaliatory counter-measures are currently small, even the specter of more aggressive protectionist policies appears to be enough to give many market participants pause. Certainly this issue bears watching and further moves in that direction could be detrimental to the longevity of the economic cycle. However, at least for now, it does not change our economic outlook.

It is quite natural to wonder what impact any of this should have on portfolio positioning. Our first concern in times like these is reaffirming with clients that their asset allocation is appropriately aligned with their individual circumstances and long-term financial goals. This knowledge gives us the confidence to withstand short-term volatility and enables us to patiently wait for the opportunities that may present themselves in unsettled markets and act accordingly when they do.

Total Return Ending 3/31/2018				Annualized		
	Qtr	YTD	1 Year	3 Years	5 Years	10 Years
MSCI All Country World Index	-0.96%	-0.96%	14.85%	8.09%	9.17%	5.55%
Russell 3000 Stock Index	-0.64%	-0.64%	13.81%	10.18%	12.98%	9.59%
S&P 500 Stock Index	-0.76%	-0.76%	13.99%	10.74%	13.25%	9.46%
Russell 2000 (Small Cap Stocks)	-0.08%	-0.08%	11.79%	8.35%	11.42%	9.81%
MSCI EAFE (International Stocks)	-1.53%	-1.53%	14.80%	5.53%	6.47%	2.73%
MSCI EMF (Emerging Markets)	1.42%	1.42%	24.93%	8.77%	4.97%	3.01%
Barclays US Aggregate Index	-1.46%	-1.46%	1.20%	1.19%	1.82%	3.62%
FTSE NAREIT All Equity REITs	-6.66%	-6.66%	-1.09%	2.89%	6.63%	6.85%
Consumer Price Index			2.3%	1.9%	1.4%	1.7%