Mitch on the Markets

Why You Should Expect Volatility in 2018

By Mitch Zacks
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2017 was a year of solid double digit returns and subdued volatility for the S&P 500. For most investors, it was a welcomed outcome for the year and may bring some fresh optimism for 2018.

But the combination of high returns and low volatility is also a tad bit unusual. Just take a look at S&P 500 returns since 2009 in the table below. Notice the magnitude of intra-year drawdowns the market experienced in any given year – some of those numbers are pretty high. You'll see that 2017 stands apart as a unique year of very little downside volatility.

Year	Intra-Year Drawdown[1]	Total Return for the Year
2009	-28%	+23%
2010	-16%	+13%
2011	-19%	0%
2012	-10%	+13%
2013	-6%	+30%
2014	-7%	+11%
2015	-12%	-1%
2016	-11%	+10%
2017	-3%	+19.42%

Source: J.P. Morgan

[1] Intra-year drawdown refers to the maximum pullback the S&P 500 experienced within the year.

2017 looks somewhat like 2013, a year when the market surged 30% and only pulled back a modest 6% along the way. Every other year (except for 2014) experienced a double-digit sized correction, which is actually quite normal for the equity markets: since 1980, the S&P 500 has experienced, on average, a -14.2% intra-year decline (according to JP Morgan). Thus, we view downside volatility as a normal, natural part of equity investing.

That's why I think 2018 is poised for a healthy, cyclical correction in the magnitude of 10% or more. Long-time readers of this column know that I shared similar thoughts on a couple of occasions in 2017, but the correction never arrived. That actually strengthens my belief that we'll see one in 2018.

The technicals appear to me to argue for possibly more downside volatility in 2018, but I think the fundamentals do, too. The combination of steep valuations, rising expectations for corporate earnings growth, and tightening at the Federal Reserve could be a formula for volatility. Optimistic market sentiment also seems more widespread, which could lead investors to ignore risk and drive up risk asset prices. Additionally, the output gap in the United States has closed for the first time in 10 years, and there is very little economic slack to spare.

Bottom Line for Investors

I cannot tell you if a correction will come, when a correction will come, how long it will last, or what the magnitude of the correction will be. If any analyst or pundit attempts to try and time a short-term market pullback, I'd recommend ignoring the forecast. I simply don't believe it can be done.

What we do know, however, is that in only two of the last 37 years (1995 and 2017), the market did not pull back more than 5% *at some point* during the year. Bull market years like 2017 are pretty rare, and thus equity investors should not get too comfortable with low volatility/high return investing. Markets tend to revert, and while I think 2018 will be another good year for stocks, I also think volatility is poised to return. Investors should keep that in mind as the year unfolds.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.