Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

The Driving Forces of Market Volatility

By Mitch Zacks
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Regular readers of this column know that on several occasions over the last year, I cautioned investors that volatility was likely to rear its ugly head at some point. In my view, it was never a matter of "if" – just a matter of when.

The experience in 2017 of very low volatility and robust returns was a great outcome for equity investors, but it was also quite unusual. By February of this year, the S&P 500 Index had gone a record-breaking 551 days (about 18 months) without experiencing a 5% drawdown. At the time, the S&P 500 had also gone about 23 months without a drawdown of 10% or more, which is also highly uncharacteristic – the market typically declines at least 10% every 18 months, on average.[1]

I'll offer just one more set of statistics to give readers perspective. These stats apply to the S&P 500:

- From January 1, 2010 to December 31, 2016:
  - 12.3% of trading days were up more than +1.0%
  - 10.6% of trading days were down more than -1.0%
- By comparison, 2017 was almost entirely devoid of volatility:
  - 1.6% of trading days were up more than +1.0%
  - 1.6% of trading days were down more than -1.0%[2]

You get the picture. The market had given us an unusually long stretch of calm positive returns, and now volatility is back. And I think it's here to stay.

Searching for the Source: What's Causing Market Volatility?

Pinpointing the exact cause of market volatility—and by extension, a market correction—is often a difficult, sometimes futile exercise. But, I think the drivers of volatility this time around are fairly clear. There are three I see.

1) **Growing Possibility of a Trade War –** in my view, a full-on global trade war would be a material negative, and could be a bear market catalyst if it escalates too far. But so far, I think the market volatility is tied more to the *uncertainty of trade policy* than

the actual tariffs themselves. To date, the only implemented tariffs are the 25% steel and 10% aluminum duties, but within a matter of a few days five of our largest trading partners were exempted.[3] China implemented tariffs on $3 billion worth of U.S. goods, but that only amounts to a ~25% tariff on 0.00136% of total U.S. exports and 0.00015% of U.S. GDP.[4] In other words, nothing meaningful has been imposed to date. All the "$50 billion" and "$100 billion" tariff talk you've heard are just threats, not actual tariffs. The trade war story, in my view, is a big dog that doesn't bite.

2) **Regulating the Technology Sector –** Mark Zuckerberg of Facebook testified before Congress last week, as the company is under intense public scrutiny for its mishandling of user data. President Trump's targeted tweets at Amazon also appeared to ratchet up pressure on the sector. I'd agree that heavy-handed regulation would be a negative for tech, but it appears that the most we might expect from Congress is some narrow legislation that applies to user data and privacy – not legislation on the digital advertising business where the revenues are. What's more, many technology companies in the sector seem to be nowhere near where Congress has its crosshairs. These companies sell software, hardware, cloud services, and so on. In my view, there's about a 0% chance any legislation would be broad enough to affect the entire sector.

3) **Tightening Financial Conditions –** the Federal Reserve is actively shrinking its balance sheet and interest rates are gradually on the rise. The U.S. Libor OIS spread, which serves as a measure of short-term credit conditions, has just about doubled in the past couple of months – signaling tighter financial conditions.[5] Meanwhile, the yield curve continues to flatten, which squeezes bank net interest margins. In my view, more so than trade or tech regulation, this factor has been putting pressure on the market and should be watched most closely.

Bottom Line for Investors

The most important question I see for investors now is: *are the perceptions of these negative forces worse than the reality of them*? Today I'd say yes, the perception is far worse than the reality. In my view, China and the U.S. will reach an agreement that is several notches below a trade war; technology regulation is likely to be narrow in scope and could take several months to pass (if at all); and finally, that we're a far cry from a liquidity or credit crisis in the current environment.

Investors should remember, too, that market volatility often creates fresh opportunities to rebalance portfolios or to look for companies whose valuations have fallen to attractive levels.

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.

[1] First Trust/S&P IQ
[2] Bloomberg
[3] Reuters
[4] Calculated based on data from the OECD and World Bank
[5] Blackrock

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