Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Why is Market Volatility Increasing?

By Mitch Zacks
Portfolio Manager

Volatility persists in the global stock market, but the media narratives haven't changed much – it's still, "fears of global slowdown, rising interest rates, flattening yield curve, and trade war with China" being most commonly cited as drivers of the selling pressure. These factors are driving uncertainty, but I'm still not convinced they are powerful enough to derail the economic growth that persists.

At the end of the day, stocks are valued based on changes in earnings expectations and changes in interest rate expectations. As corporate earnings rise greater than expectations, stock prices go up. And as interest rates increase more than expectations, stock prices go down. Nothing that occurred over the past two weeks justifies a large enough change in either earnings estimates or interest rate expectations to justify the higher levels of volatility that we have been witnessing. Still you may be wondering, *"What is the cause of this volatility?"* In this week's piece, I will dive into these different factors and the impact they have on the markets and current volatility.

When Do Interest Rates Signal a Recession?

While it is true that the yield on two-year treasuries slightly rose above the yield on five-year treasuries, this is by no means a signal of a coming recession. When trying to use the term structure of interest rates to predict recessions, the key metric is the differential between the ten-year yield and the two-year yield. The ten-year yield is currently at 2.878% and the two-year yield is at 2.742%. While the ten-year yield is only slightly above the two-year yield, it is by no means an inverted yield curve at this point in time.

If anything, a thirty-year yield of 3.138% and a one-year yield of 2.715% seems to be indicating that inflation will remain very benign over an extended period of time and interest rates are anticipated to remain relatively low for multiple years. Both low interest rates and low inflation should be beneficial to asset prices across the board.

Earnings Estimates Remain Strong

So that brings us to earnings. Was there something that occurred over the past week with respect to tariff expectations that lead the market to believe corporate earnings were going to be significantly lower than previously expected? The answer is clearly no – earnings estimates have not been ratcheted down significantly as has historically occurred when large economic shocks have hit the economy. In fact, the most recent earnings reporting season has been relatively strong.

Trade War with China

Well, could the selling this past Tuesday be due to the market suddenly realizing that the trade war with China is going to dramatically broaden in both duration and magnitude? A trade war with China that is longer than currently expected would put downward pressure on corporate earnings by reducing GDP growth. This explanation is unlikely as a moderately long trade war with China is currently already being priced into stock prices, it is not as if the market collectively believed the administration was not serious about tough negotiation with China and then suddenly awoke from its slumber due to a random tweet.

What Triggered Market Selling?

Little changed fundamentally over the past two weeks with regard to interest rate expectations, earnings expectations and the potential length of a trade war with China. So why did the last week of November witness some of the strongest historical returns in quite some time and this past Tuesday saw some of the harshest selling in several years?

To understand what is going on you need to focus on psychology. There has been ongoing research trying to explain market sell-offs. Several researchers had an interesting idea to try to explain why intense market selling occurs: instead of looking for an economic explanation – a repricing of earnings due to a policy change or changing expectations of future interest rates – why not instead go and ask institutional investors why they sold during the market downturn.

The findings were fascinating but not surprising – what they discovered is the main reason large institutional portfolio managers sold during market corrections is that stock prices were falling. Investors were reacting to price movements instead of to changing fundamentals – the selling effectively snowballed because large institutional investors sold stocks because other large institutional investors were selling stocks.

The problem for today's market is that this lemming-like behavior of selling stocks because others investors are selling stocks is becoming a self-fulfilling prophecy due to algorithmic trading. If we look at a sample of three of the largest multi-strategy hedge-funds they might collectively manage

only $100 billion dollars in assets but through leverage they can deploy half a trillion dollars. Additionally, most of these firms are focused on using leverage to generate returns on a very short-term time horizon.

Essentially, multiple firms, by analyzing past price movements independently through various means, have come to the same conclusion that the psychologists examining market corrections came to – that during large negative market movements selling accelerates.

This bias is then ingrained in multiple trading strategies all of which basically start firing at the same time under the same conditions. As a result, mild selling due to changes in fundamentals has the capacity to snowball much more quickly in today's market than it has historically.

Bottom Line for Investors

The key lesson for investors is relatively straightforward – as much as possible try to ignore price movements when making buy and sell decisions and instead focus on changes in fundamentals. The silver lining in the increased volatility is that the higher volatility should result in a higher rate of return for long-term equity investors as they need to be compensated for the volatility which does not look like it can be diversified away.

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.

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