Zacks INVESTMENT MANAGEMENT

Portfolio Manager Investing Insights

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4 Reasons to Expect More Volatility in 2020

Equity investors should justifiably feel good and confident entering the new year. 2019 was a strong year for US and global stocks, and as it stands today the economy looks poised to add more growth in 2020 – with a rebound in corporate earnings to boot.

Since I'm about to give readers four reasons to expect more volatility in 2020, you might think I'm here to spoil the party. Quite the contrary! I think volatility is a good thing – it's a normal, natural part of equity investing, and experiencing volatility from time to time means the market is functioning rationally, in my view. It is also important for investors to remember that volatility works both ways – delivering blows to the downside and triumphs to the upside over short periods of time.

When volatility happens, I think it's almost always best to stay patient and let the volatility run its course. My advice in 2020 will almost certainly be no different.

Reason #1: We Can't Ignore History

In a column late last year, I wrote that we should expect volatility in 2020 because history tells us we should. If you look at the S&P 500 over the last 38 years (1980-2018), [1] you'll find that not only are corrections frequent, *they're the norm.*

The average intra-year correction for the S&P 500 since 1980 is -13.9%. There are very few years in history where the S&P 500 didn't fall at least -5% within the twelve-month period. In the last 38 years, it's only happened twice: 1995 and 2017. In 2019, the biggest drawdown we saw was -7%, making it a below-average year for equity market volatility.[2] In 2020, I think we're due for a mean reversion, which might imply a correction more in tune with longer-term historical averages (-10% or more).

Reason #2: Low Volatility Generally Gives Way to High Volatility

Since the middle of October 2019, the S&P 500 Index has not moved 1% (or more) in either direction in a single day of trading. This low volatility streak is one of the longest the market has seen in 50 years, and it underscores the steady march higher that stocks have been on for months. History tells us that these extended periods of low volatility tend to give way to periods of high volatility.

The last time the low volatility streak happened for this long was just before January 2018 and October 2018,[3] which marked the beginning of sharp corrections:

S&P 500 from 2017 – Present

Source: S&P Dow Jones Indices[4]

Reason #3: Stock Buybacks are on the Decline

The windfall many corporations earned in the aftermath of the 2018 tax cut essentially went to one of three places: new investments, stock buybacks, or cash on the balance sheet. Stock buybacks are a corporation's main tool for reducing outstanding supply of shares, therefore boosting existing shareholder value. From a supply – demand standpoint, lower supply means upward pressure on price, which is good for shareholders.

Since 2011 and particularly in 2018, the demand generated by stock buybacks was higher than demand by institutions such as mutual funds. In short, buybacks have been important. But early estimates show that stock buybacks were down approximately 15% in 2019, with more declines expected in the new year.[5] Another factor to consider: fewer buybacks could mean a tougher road for corporation's exceeding earnings per share targets, which could make investors jittery.

Reason #4: A Far from Straightforward Election Year

Election years have historically been good for stocks, and I think 2020 will be too. But I also expect some bumpiness given all of the unknowns with this particular election. When I say 'unknowns,' I'm not necessarily referring to the political outcome. I'm more concerned with foreign interference, contested results, civil unrest, and other extraneous factors that might lead to a period of political instability. I ultimately believe the nation will accept the result and move on, but I expect some choppiness in the build-up through November.

Bottom Line for Investors

It is worth repeating that volatility is a good thing for equity markets, and experiencing it – while often unsettling – is totally normal and expected. In my view, the S&P 500 is due for a correction this year on par with historical averages, in the –10% to –15% range. My hope is that long-term investors will keep the possibility of a market correction in mind this year, and remain calm and patient if (or when) volatility takes hold.

ABOUT MITCH ZACKS

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[1] J.P. Morgan, December 31, 2019. https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/guide-to-the-markets/viewer

[2] J.P. Morgan, December 31, 2019. https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/guide-to-the-markets/viewer

[3] The Wall Street Journal, January 16, 2020. https://www.wsj.com/articles/stocks-have-rarely-been-this-quiet-in-the-past-50-years-11579179600?mod=article_inline

[4] S&P Dow Jones Indices LLC, S&P 500 [SP500], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/SP500, January 27, 2020.

[5] CNBC, December 16, 2019. https://www.cnbc.com/2019/12/16/goldman-has-a-worry-could-hit-earnings-cause-volatility-in-2020.html

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- Phase 1 of the US-China Trade Agreement
- The coronavirus spreads with 20,000 reported cases
- PMIs point to modest growth ahead
- How will the official Brexit affect the UK's economy?

"Phase 1" of US – China Trade Agreement Taking Form

China has agreed to cut tariffs by 50% on approximately $75 billion of US imports, while also increasing purchases of US goods by up to $200 billion. It remains to be seen if China is able to fulfill its promises of boosted purchases, but an early sign of compliance came when China agreed to cut tariffs effective February 14. This news comes as trade figures were released this week showing that the US trade deficit with China shrunk for the first time since 2014.[1] While shrinking deficits are a distinct goal of trade negotiations, we would caution against seeing this as good news. The trade deficit shrunk because imports fell faster than exports, meaning that total trade declined – a sign of weaker global demand, in our view.

Coronavirus Spread Continues

The coronavirus outbreak has now eclipsed 20,000 reported cases and over 500 deaths, and all signs point to the crisis getting worse before it gets better. The economic impact for China and the global economy will not be zero, in our view. Millions of people in China are on lockdown and major corporations have all but shut down operations throughout the country. More recent announcements include Airbus shutting a factory that is responsible for nearly 10% of plane production; the Yum Corporation (owner of KFC, Pizza Hut, and other popular fast food chains) has closed over 30% of its restaurants; Starbuck's, Apple, and Levi's have closed thousands of retail stores; many airlines have significantly reduced or eliminated flights to China.[2] All told, China may very well see over 2% trimmed from Q1 GDP, and the US could feel the effects to the tune of 0.5%, in our view.

PMIs Point to Modest Growth Ahead

US purchasing managers are painting an optimistic view of the US economy looking out over the next couple of quarters. Purchasing managers are those responsible for ordering supplies, maintaining inventories, and managing supply chains across the US services and manufacturing sectors. Feedback from January's reporting show that these purchasing managers are seeing solid activity and expecting modest but nicely positive economic growth. Factory activity in January saw its first positive reading in six months while services activity posted its strongest performance since August.[3]

Brexit Becomes Official

After years and years of bitter infighting and political indecision in Britain, Brexit has finally taken place. Britain formally withdrew from the European Union last Friday, setting the course for political and economic independence for Britain. Whether or not the move benefits Britain economically over the long term remains to be seen, but in the short-term consensus is that the UK may feel a slight bit of pain, as new trade deals are hashed out and as businesses consider their future in the UK versus Europe. London and Brussels (EU headquarters) have until the end of the year to hammer out the terms of the official exit.[4]

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[1] The Wall Street Journal, February 6, 2020. https://www.wsj.com/articles/china-to-cut-tariffs-on-75-billion-of-u-s-goods-11580967540?mod=djem10point

[2] The Wall Street Journal, February 5, 2020. https://www.wsj.com/articles/coronavirus-ripple-effects-hit-production-at-airbus-hyundai-11580904473

[3] Institute for Supply Management, February 3, 2020. https://www.instituteforsupplymanagement.org/ISMReport/MfgROB.cfm?SSO=1

[4] The New York Times, January 29, 2020. https://www.nytimes.com/2020/01/29/world/europe/brexit-brussels-eu.html

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