A Message from the TOPS® Portfolio Management Team

Volatility Returns to Markets – February 6, 2018

We often remind investors, "Don't mention return without mentioning risk in the same sentence." Risk and return are linked components of equity markets and typically shouldn't be singled out. However, we have recently experienced an abnormally-prolonged period of markedly low levels of volatility (a popular gauge of overall risk). The recent lull in volatility has made many investors forget it is normal for markets to see significant intra-year drops in value, even in years where positive returns result.

In fact, the average intra-year drop for the S&P 500 from 1980 to 2017 was 14.1%. However, the annual returns were positive in 28 of those 37 years. The following chart covers multiple examples of high positive return years in the S&P 500 over the last 20 years, where intra year declines exceeded 10%:

YEAR	INTRA YEAR DECLINE	TOTAL RETURN FOR THE YEAR
1997	-11%	+31%
1998	-19%	+27%
1999	-12%	+20%
2003	-14%	+26%
2009	-28%	+23%
2010	-16%	+13%
2016	-11%	+10%

Source: JP Morgan Asset Management

What May be Causing the Recent Rise in Volatility?

As we have mentioned in commentaries over the last few years, significant recent gains in U.S. stocks have led to stock valuations which are higher than historical averages. While historically low levels of volatility and historically high stock valuations is a euphoric combination for markets, it cannot be expected to continue forever. As mentioned above, risk and return are proverbially linked. Given overall metrics and normal course of markets, some sort of mild pullback would be the norm, rather than the exception.

The most recent drop in U.S. stocks, starting on February 1, seemed to be accelerated by wage data released last Friday in the Employment Report. Relatively low volatility in the U.S. has been accompanied by both low inflation and low interest rate levels. The concern with an Employment Report showing wage growth is that such growth could spark overall inflation, causing the Fed to raise interest rates faster (or at least with more surety). Further, there is concern rising interest rates could make heightened valuations more vulnerable.

Some Closing Thoughts

As one of our partner analysts, Dr. Ed Yardeni, recently noted, "the *outlook for earnings remains very upbeat. Industry analysts have raised their consensus S&P 500 earnings estimate for 2018 by $9.00 per share over the past seven weeks to $155.26 during the week of February 2.*" Likewise, "*the Atlanta Fed is now projecting real GDP growth at a 5.4% annual rate in the first quarter, which would be the fastest growth for any quarter since 2003",* according to First Trust. The primary drivers of the recent overall economic and market strength in the U.S. remain. We monitor several signals in markets for recessionary signs, and there is no overall indication of a recession coming soon.

Higher wage inflation doesn't always lead directly to higher price inflation. The signal which seems to have driven markets to recede in the short term is not a direct signal. As such, there is no news out in the last 4 days which has substantially changed the overall market landscape from when it rose just a few days before.

With over 75 years of combined investment management experience and a disciplined institutional investment process, the TOPS Team is seasoned to expect events like we have experienced in the last few trading days. While it's not fun to see red numbers on our monitors, we understand periods like this are necessary and normal in the course of equity investing. Likewise, we understand these events can be stressful on our investors. We remember speaking to clients when the S&P 500 sat at 735 in 2009, only to close at 2872 on January 26, 2018.

The TOPS team spends considerable time monitoring and discussing markets to ensure we are appropriately investing client assets. Many investors have experienced recent activity in their accounts, as we have rebalanced portfolios and made some strategic adjustments. While we can't control equity markets, we can monitor risk and appropriately manage investments with a goal of optimizing the risk versus return trade off over time.

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