Global Asset Management

Putting recent volatility into perspective

After an extended period of strong performance, volatility has returned to the equity markets with the S&P 500 Index down 7.8% since January 26. Volatile markets tend to take over media headlines, so it's important to isolate the facts that have been driving market performance to provide perspective during periods of volatility.

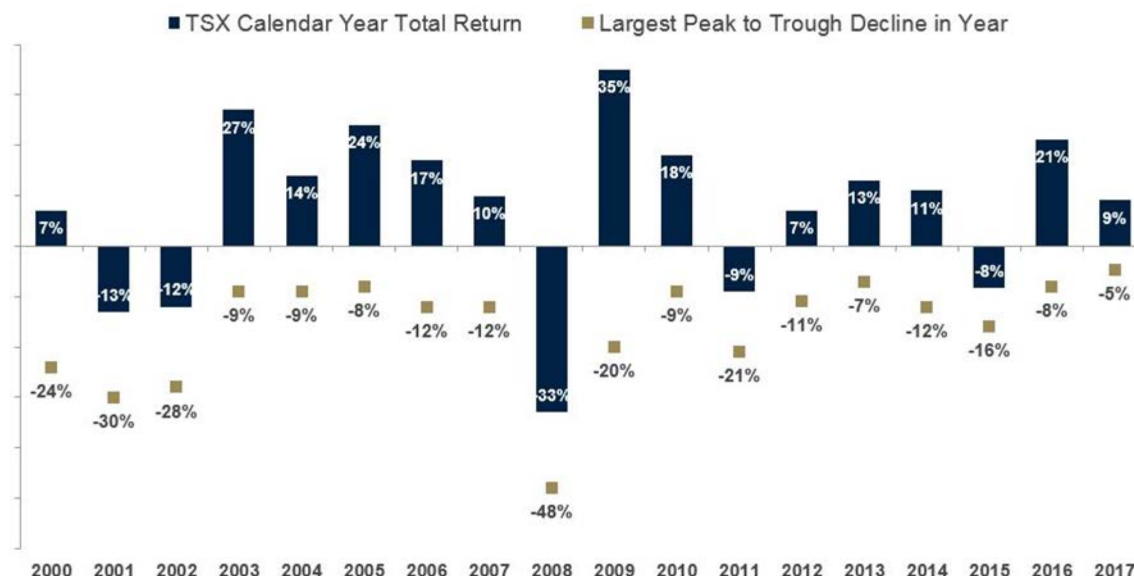
Eric Lascelles, Chief Economist at RBC Global Asset Management, shares the following thoughts on recent developments:

- As to what underpins this sudden change in sentiment, it wasn't any sudden dose of bad news. No wars, corporate bankruptcies, recessions or other major macro shocks caught the market by surprise.
- To the contrary, this development fits more neatly into two other categories:
  - First, markets had been abnormally calm for an extremely long time. Bursts of volatility do come along every now and again, and this one was well overdue in a purely chronological sense. The high level of complacency and optimism that has been on display lately created a vulnerability.
  - Second, the bond market had started to respond to the reality of tightening economic conditions, rising inflation and therefore central banks set to continue removing stimulus. The big increase in bond yields over the past few weeks, preceded by steady gains over several months, had started to dim financial conditions. The final straw appears to have been the U.S. payrolls report, which revealed strong hiring but also stronger-than-expected wage growth (a negative for corporate income statements and a hint about the late stage of the business cycle).
- It is unusual for stocks to be down at the same time that bond yields are up (they have risen over the past several weeks, if not the latest few days). This upward shift in the yield curve signals investors still have confidence in the economy.

In all of this, let us recall that the economic signals are still quite strong (if no longer accelerating as much as before), central banks are not obviously making any policy errors in raising rates and stock market valuations do not look too badly offside in a structurally low interest-rate environment. However, it is undeniable that the business cycle is fairly old. Our latest work argues that we are still in the "late" stage of the cycle, meaning the next downturn would normally occur within the next couple of years, but not obviously tomorrow.

As we can see from the chart below, pullbacks like we have experienced in the past few trading days are common and part of normally functioning capital markets as they digest new information. Since 2000, the average of the largest annual peak-to-trough pullbacks for the S&P/TSX Composite Index was over -16% while the average annual return was over 7.7% during that time.

Even the good years have dark days



Source: Bloomberg. Performance reflective of S&P/TSX Composite Index, denoted in Canadian dollars. Performance data as of December 29, 2017. An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results.

When faced with uncertainty, it is human nature to react in an attempt to regain control. But trying to time the market has not proven to be successful over time; in fact, it can have significant, negative consequences for your long-term financial goals. Instead, market volatility should be viewed as an opportunity to evaluate your investment objectives and financial plan with an advisor. This is an important way to ensure that your investment strategy is on track to help you meet your longer-term goals.

Data as of February 5, 2018 unless specified otherwise.

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