BLOG

STOCK MARKET VOLATILITY: A RISE IN FEAR OR A RETURN TO NORMAL CONDITIONS?

Increased volatility in the U.S. stock market has been a recent topic of debate in the financial media. As a typical rule of thumb, when stock markets go down, volatility goes up. From Presidential tweets to the Syrian conflict to rising interest rates, many different topics have served to weigh on the stock market in 2018, resulting in a subsequent rise in volatility. The question becomes: is it such a bad thing to see relatively higher volatility?

Paradoxically, this recent rise in stock market volatility may not be so bad. Far from indicating that investor fear or panic is on the rise, slighter higher volatility levels in the U.S. stock market indicate a healthy and functioning market. Indeed, the return of moderate volatility is actually just a return to more normal financial conditions. 2017 was an exceptionally calm year for the U.S. stock market. Stocks rose fairly steadily throughout the year, with hardly any corrections or drawdowns. Indeed, stock market volatility, as measured by the "VIX" volatility index, registered all-time lows in November of 2017. In other words, the U.S. stock market had never been calmer than around Thanksgiving of last year. It was a great time to be invested in U.S. stocks, and fortunately for our clients we were fully invested to take advantage of these conditions.

But all-time low volatility is not a persistent condition that can be maintained in a healthy financial market. The ebbs and flows of markets are what allow for price discovery and rational behavior: markets reflect constantly updated information that rewards companies with unexpectedly positive results and profitability, while penalizing companies with unexpectedly negative results and a lack of profitability.

Consider the metaphor of a forest fire. Forest rangers and biologists know that small amounts of volatility (in this case fires) are actually a good thing, which help to maintain a healthy forest. By suppressing small fires and preventing any burns whatsoever over the course of several decades, a forest could become unsustainably full of natural material that would be ready to burn. When a forest fire does finally occur after decades of artificial suppression, the fire would be huge, unmanageable and catastrophic.

The same concept holds true for the financial markets. By keeping volatility artificially low over time, markets tend to go up with relatively few drawdowns. We know that markets are cyclical and that recessions, and their concurrent stock market corrections, are a natural part of investing. By limiting volatility in the short-term, either through government intervention or simply a manic bull market, the market is set up for a much greater fall at some point down the road.

Which brings us back to the recent moderate rise in volatility experienced in 2018. Should we be concerned? In short, the answer is "no." President Warren G. Harding coined the expression a "return to normalcy." In fact, a "return to normalcy" in the world of volatility is actually a quite welcome development for the financial markets.

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