LORD ABBETT

MARKET VIEW

Volatility: Behind Last Week's Market Mayhem

February 12, 2018

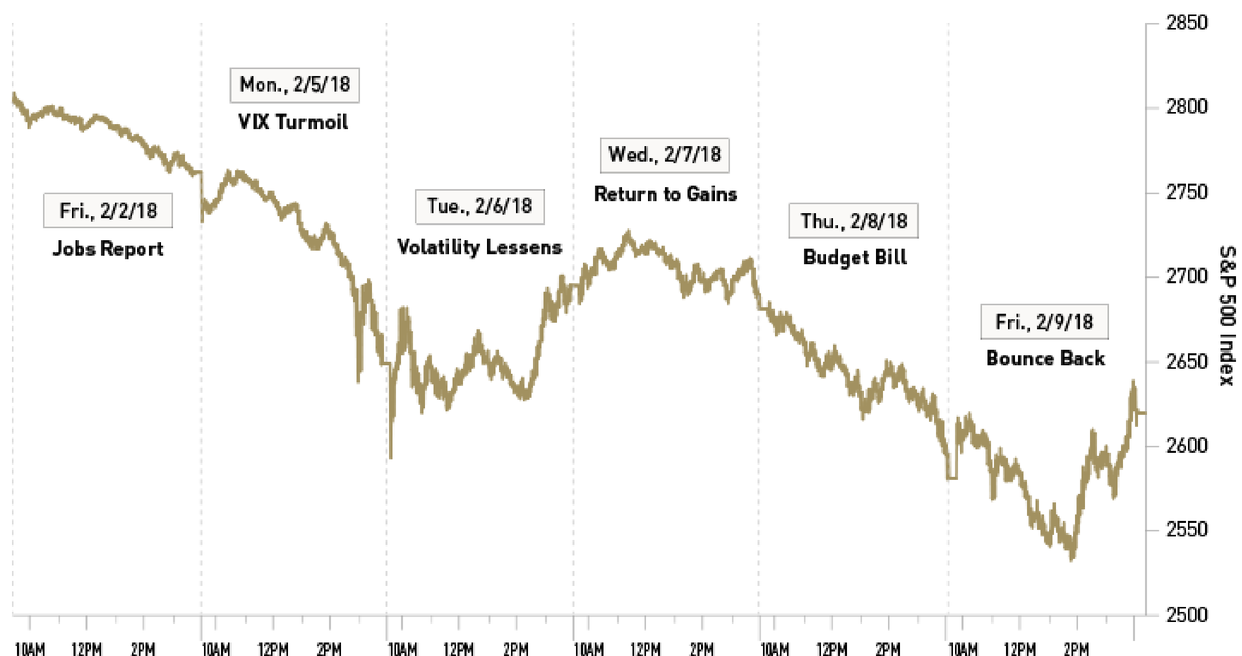
Last week's equity rout largely reflected overblown fears about inflation and turmoil in VIX-related trades, not actual fundamentals.

Following a week when the Dow Jones Industrial Average (Dow) swung 1,000 points or more on every day but one, investors and investment professionals alike are searching for answers. What caused the rout? And is there more to come?

Let's take a look back at the week's events, starting with the previous Friday's (February 2) release of the U.S. Bureau of Labor Statistics' (BLS) January 2018 employment report.

Chart 1. The Market Rout Began with a Jobs Report That Triggered Inflation Concerns

S&P 500® Index prices, intraday, February 2–February 9, 2018



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Friday, February 2—The market's primary concern about the BLS jobs report was not the number of jobs added (the increase in nonfarm payrolls was only slightly higher than the average of the past 12 months) but rather the *pace of wage growth* and its implications for inflation. Average hourly earnings (AHE) increased 2.9% year over year, sending U.S. equity prices steeply lower and U.S. Treasury yields sharply higher. **As we said at the time**, most of the gain was in the form of bonuses and other one-time payments—nonrecurring events that are, therefore, not necessarily indicative of structural wage inflation.

While the subsequent sell-off seemed to be driven by the report's apparent inflation implications, long-term inflation expectations (as measured by the Five-Year, Five-Year Forward Inflation Expectation Rate) only rose modestly, and are still within the U.S. Federal Reserve's desired range at 2.46%, which would suggest that market participants currently view inflation at a very healthy and controlled level.

Monday, February 5—On this day there was a spike in equity market volatility, with the S&P 500® Index falling 4%, thus giving back the year's gains (year-to-date 2018) in a single day. Implied volatility (as measured by the CBOE Volatility Index, or VIX) spiked 115%, to 38. That certainly was bad news for investors who were betting that volatility would stay low, and it was arguably worse news for investors in exchange-traded products who shorted volatility. According to *Barron's*, after the market's close on Monday, the two largest such products each fell about 90%, shedding around $3 billion in value. One of them, the VelocityShares Daily Inverse VIX Futures Short Term exchange-traded note (ticker: XIV), a debt obligation underwritten by Credit Suisse, collapsed.

Shorting volatility may have seemed like easy money in a market with low volatility, but the sudden spike in market volatility saw investors instead frantically trying to unwind their positions.

Tuesday, February 6, and Wednesday, February 7—After an eventful couple of days, the market appeared to regain its footing in the middle of the week, as volatility returned to more typical levels and the S&P 500 crept back into positive territory for the year.

Thursday, February 8—Then, on Thursday, the specter of a U.S. government shutdown and the emergence of a spending bill with large deficit-expansion repercussions fueled investor fears of substantially higher interest rates, and led to another volatile day in the equity markets, officially pushing equities into "correction" territory (that is, a drop of 10%).

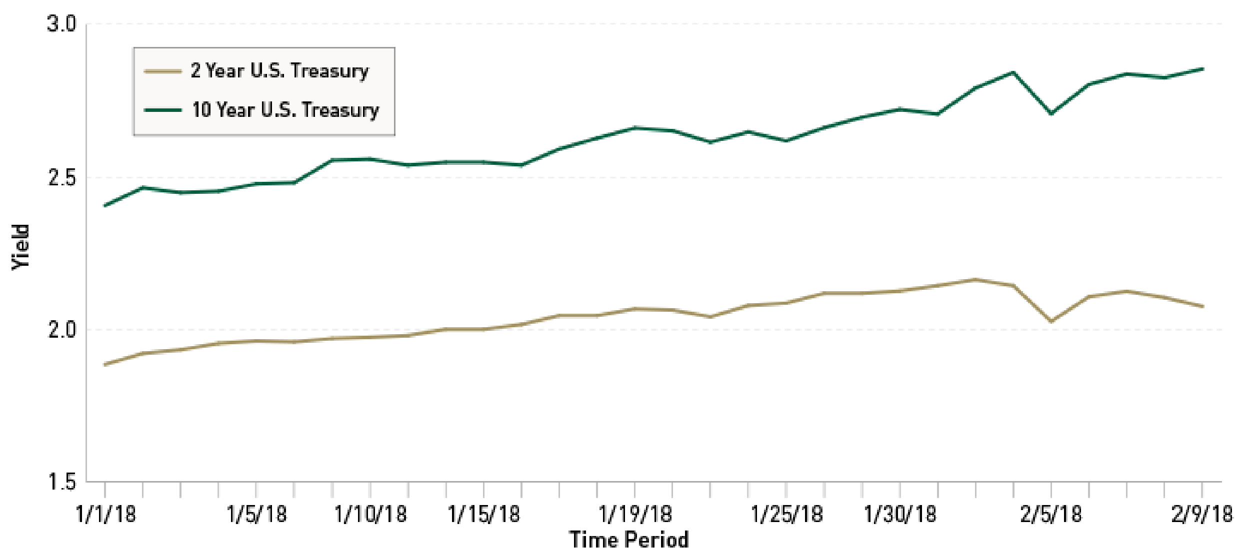
Friday, February 9—A bounce-back in the final hour of trading on Friday was a welcome event, but major U.S. indexes still ended the week more than 5% lower—their worst loss in more than two years.

The Market Is Not the Economy

In last week's ***Economic Insights*,** we opined that recent equity market volatility is an isolated event related to activity in the equity VIX market, *not* to a sudden rise in fundamental risk. Among the reasons we cited were the strength of the U.S. economy and stable inflation expectations. There simply are no indications of a U.S. economic slowdown. If anything, recent economic data have exceeded expectations more than usual. And the fact that inflation expectations remain benign suggests that the rise in bond yields that we've seen recently could be limited.

Chart 2. The Recent Rise in Bond Yields May Be Limited

Two- and 10-year Treasury yields, January 1–February 9, 2018



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Strong, long-term fundamentals may even be evidenced in the fact that the credit markets have held up very well over the past week. Investment-grade spreads, for example, were essentially unchanged during the week the equity markets were falling, and high-yield spreads widened only modestly.

Moreover, robust corporate earnings and sales growth have shown no signs of slowing down. In fact, of the 250 companies in the S&P 500 that have reported earnings (as of February 2, 2018) for the fourth quarter of 2017, 76% have beaten earnings estimates and 79% have exceeded sales expectations. Moreover, EPS (earnings per share) is up 12.4% in the same period (compared with the year-ago quarter) and sales are up more than 10%. Those are extraordinary results.

We believe the lack of cross-asset volatility between stocks and bonds over this period, and the strong underlying fundamentals of corporations and the economy, support our contention that last week's rout in the equity markets was related to exaggerated fears about inflation and the resulting frenetic trading activity in the equity VIX market. *The market, after all, is not the economy.*

A Final Word

Historically, when the market experiences a volatility spike against the backdrop of a strong economy—regardless of the catalyst—**equities** and credit tend to regain their footing relatively quickly, and typically are stronger three, six, and 12 months down the road.

Table 1. Historically, Equities and Credit Have Revived Quickly

Index/Asset Class	Forward Returns After S&P 500 Daily Decline of -3% to -6%			
	1 Month	3 Month	6 Month	12 Month
S&P 500	1.0%	3.0%	5.0%	10.0%
Global Equity*	0.0%	1.0%	3.0%	8.0%
U.S. Investment-Grade Spreads	+17 bps	+1 bps	-28 bps	-74 bps
U.S. High-Yield Speads	+65 bps	+18 bps	172 bps	-195 bps

Source: Morgan Stanley. *Global Equity as represented by Morgan Stanley International Capital Markets (MSCI) All Country World Index. The information shown is for illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future. **Past performance is not a reliable indicator or a guarantee of future results.**

Short-term returns may be mixed, but over the long term, spikes in volatility historically have represented a buying opportunity when the fundamental backdrop is as strong as it is today.

IMPORTANT INFORMATION

A Note about Risk: Keep in mind that all investments carry a certain amount of risk including possible loss of the principal amount invested. No investment strategy, including diversification and asset allocation, guarantees a profit or protects against a loss. Stock markets, especially international markets, and investments in individual stocks are volatile and can decline significantly in response to issuer, market, economic, industry, political, regulatory, geopolitical, currency fluctuations, and other conditions. These risks are magnified in emerging markets. The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Moreover, the specific collateral used to secure a loan may decline in value or become illiquid, which would adversely affect the loan's value. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. Lower-rated bonds may be subject to greater risk than higher-rated bonds.

No investing strategy can overcome all market volatility or guarantee future results.

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Glossary of Terms

A **basis point (BPS)** is equal to 1/100th of 1%, or 0.0001.

U.S. Treasuries are securities – such as bills, notes, and bonds – that are debt obligations of the U.S. government.

The **Chicago Board Options Exchange (CBOE) Volatility Index (VIX)** shows the market's expectation of 30-day volatility, using the implied volatilities of a wide range of S&P 500 Index options. It is widely used as a measure of market risk. .

The **Dow Jones Industrial Average** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

The **Five-Year, Five-Year Forward Inflation Expectation Rate** is a measure of expected inflation (on average) over the five-year period that begins five years from the current date.

The Morgan Stanley Capital International (MSCI) All Country World Index (ACWI) (USD) captures large- and mid-cap representation across 23 developed markets and 24 emerging markets. With 2,495 constituents, the index covers approximately 85% of the global investable equity opportunity set.

All Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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