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Volatility

Investors despise price volatility. Currently, people are worried about the recent free-fall in oil prices and the plunge in bond yields to below 0 percent in the Eurozone and Japan. Last week, Swiss authorities allowed the Swiss Franc to float freely to the Euro. This surprise move caused the Franc to soar by 10 percent to the euro in one day. Conversely, the Swiss stock market declined by almost 10 percent, also in one day.

In today's piece, aptly named "Volatility," we will measure recent stock market volatility and discuss what the return of volatility to the global financial system may mean.

Background

One of the central themes of our 2015 capital market outlook was our view that price volatility would accelerate in 2015. Extraordinarily important headlines and actions are being released on a regular basis, each release drives price volatility higher in the global financial system.

Stock prices are driven by many factors.   Expected corporate earnings, interest rates, monetary flows, political events and liquidity within the banking system all have the power to roil the markets. The Dow Jones Industrial Average (DJIA) is not a good representation of overall global stock values, but it has been a standard which many investors recognize.

Recent Trends & Trading Patterns

The Dow Jones Average closed at 18,053 – an all-time high – on Dec. 26, 2014. Between Dec. 26, 2014, and Jan. 16, 2015, the index lost 542 points or 3 percent of its value. Although this change is not a big deal, the downdrafts, at times, seem to be more harrowing than the record would indicate. If you believe this, you're starting to understand the increase in the daily price volatility we've experienced over the last few months.

Just The Facts

Have the U.S. stock prices become more volatile over the last several months, and if so, by how much? To more fully understand price volatility patterns, we conducted an informal study where we analyzed two recent periods. The first period – June 30, 2014, to Sept. 30, 2014. The second, Sept. 30, 2014, to Jan. 16, 2015.

	June 30 – Sept. 30	Sept. 30 – January 16
Number of Trading Days	64	75
Number of days where DJIA was up/down more than 100 points	14	34
Percent of trading days where DJIA rose/fell more than 100 points	21%	54%
Average number of points between monthly high/low prices	608	1091

When measured by the frequency of "100" point days, the DJIA's price volatility has more than doubled between Q2 2014 and the last three and a half months. Perhaps the most stunning piece of detailed data is that the index rose/fell by at least 100 points during 70 percent of the trading days last October and in 73 percent of the trading days so far in January.

The call for increased volatility in asset values for 2015 is playing out.

Reminder

Why did we make the call that price volatility was probably going to rise in 2015? For a number of reasons. Let's quickly review as to why asset prices (particularly stocks and commodities) would show higher levels of volatility in 2015. Price volatility tends to rise due to uncertainty – and surprises – both positive and negative.

By definition, we can't forecast a "surprise." However, the sheer number of uncertainties currently present in the world, be them economic or socio/political, seem to be much higher than normal. Consider:

- Will Europe stay out of recession? Much of the recent economic data points to continued economic weakness, particularly around the "fringes" of the continent.
- Will the European Central Bank (ECB) launch a meaningful, effective quantitative easing strategy?
- Will Japan finally dig their way out of a 25-year deflationary spiral?
- How much will China's GDP growth rate contract?
- The value of the Ruble has collapsed. It appears the Russian economy is following. Will Putin strike out militarily again?
- Will Iran continue its drive toward nuclear proficiency, and if so, will Israel respond?
- What economic and political ramifications will occur due to the more than 50 percent decline in oil prices?
- Terrorist activity seems to be on the rise, as recent actions in Paris attest.
- Will the Greeks attempt to exit their participation in the Euro/EU?
- Will the Federal Reserve raise interest rates this year, and what impact on the financial system will this change bring?

All of the above are weighing on people's minds, according to Richard Edelman, the chief executive of Edelman, the world's largest public relations consultancy. Annually, Mr. Edelman publishes his "Edelman Trust Barometer," which is driven by a surveying 33,000 people in 27 different nations. In his most recent survey, half the respondents indicated trust in business and institutions has slipped below 50 percent, the lowest reading since 2008.

Except for the U.S. economy, most parts of the world harbor potential risk factors. The United States appears to be a harbor in a tough economic/socio/political sea. In Mr. Edelman's survey, U.S. participants registered an increase in "institutional trust." Most of the "gloom" in his report resides in Europe. Given the severity and widespread nature of the noted risks, it's not unthinkable that stock values should be rising and falling rapidly.

Other Thoughts

Over the last several years, the Federal Reserve and the Bank of England have acted as the world's supplier of banking liquidity through significant quantitative easing policies. The monetary/liquidity baton is currently being passed from the Fed and the BOE to the European Central Bank (ECB) and the Bank of Japan (BOJ). While this "pass" may occur without a serious hitch, risks of a bungle are present. Investors sense this as something of which to be aware. Again, price volatility has been rising.

The financial world is facing all of the above risks and U.S. stock values are roughly one standard deviation above their long-term (50-year) normal valuation bands. Looking at current valuation levels compared to the last 20 years, stock prices don't look particularly stretched or undervalued. If stock prices were not stretched, the downside in stock prices (if a serious correction were to occur) may not be that significant. That is currently not the case.

Bottom Line

Will a recession occur in the United States if a number of the risks mentioned above come to fruition? Bear markets (more than 20 percent decline in stock prices) tend not to occur unless accompanied by a recession. The weight of the current economic evidence suggests the United States is far from a recession. This is not the case for Europe. This coming week, investors will be concerned about the upcoming election in Greece – the results of which may determine whether Greece will stay in the Euro/EC or flee the common currency.

That being said, recent sentiment indexes in the United States are the best they've been in 10 years. Small business sentiment readings have recently risen back into a "normal" range, suggesting further hiring this year in this sector. People "feel" pretty good about things – their ***willingness to transact*** is the highest we have seen in many years. Interest rates are low and jobs are becoming more plentiful.

We've been calling for price volatility to rise within the stock market this year, as compared to the last couple of years. As today's piece suggests, this has been happening over the last few months. Expect price volatility to continue as the world's investors wrestle with the risks. It is highly possible we may experience a 10 – 20 percent price decline in U.S. stocks during 2015 although we don't currently see a cyclical "bear" market (more than 20 percent decline) unfolding within the U.S. stock market at this stage.

All of this being said, we would treat downward price movements, if they occur, as buying opportunities rather than reasons to sell equity positions.

We will be back next week.

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