The Return of Volatility

Investors should be on the lookout for an increase in volatility going forward. Volatility will likely increase as market participants face more uncertainty. Forecasts are calling for diminished equity returns and negative returns on bonds. With global stock markets priced for perfection, equity investors will need to focus on quality companies that can control their own fate, irrespective of macroeconomic trends. After all, many of the things that we have all come to count on are changing.

The Fed Put

Investors have been able to count on supportive monetary policy for some time now. The US Federal Reserve Bank has been a leader in this movement, but they are by no means alone. Low interest rates all over the world have led to market participants taking on more and more risk, driving equity prices to higher and higher levels as the appeal of stocks only grew in comparison to lower and lower interest rates on bonds. This phenomenon even has a name: TINA, which stands for There Is No Alternative (to owning stocks). However, things seem to be changing.

For starters, the forty-year rally in US Treasury rates has ended. This unprecedented move saw the yield on US 10-year notes fall from 16% in 1981 to 50 bases points a year and a half ago, when the pandemic got to its scariest point. The reversal has begun, though. The first jobs report of this year, following a recent pattern, was weaker than expected, but it still took the unemployment rate down to 3.9%. And with unemployment below 4% the Fed is in a position to be able to decide that one of its jobs, that of beating back unemployment is done.

The Fed’s other job, though, maintaining inflation at a healthy but still reasonable level is far from done. What is going to happen to interest rates? Could there be an interest rate lift-off as early as this quarter? Accommodative monetary policy has been a steady staple, part of the investment landscape for as far back as notoriously short-term thinking stock market participants can remember. But what if that changes? Where might that leave all of us equity investors, who are by the nature of our equity investments holders of the venerable Fed Put?

Beta, Delta, Omicron & GAMMA

Although not one of us is happy about it, the Coronavirus and COVID-19 have become a fixture in our daily lives. It was assumed that we would get rid of them. We certainly wanted to rid ourselves of them, or so it seemed. However, a combination of vaccine reluctance, virus mutations and other factors has meant that not only is this virulent disease still with us, but the U.S. is ending the year with a record number of cases.

The path of the pathogen has investment implications. If yet another resurgence of the pandemic stifles economic growth, then the markets will be faced with slackened demand and a third round of the stay-at-home trade in which a very short list of very large cap growth stocks once known as the FAANG stocks—but which have now morphed into the GAMMA stocks: Google, Apple, Microsoft, Meta and Amazon will dominate market performance.

This unusually narrow bull market is not merely an American thing. The French were treated to a KHOL Christmas in which Kering, Hermes, L'Oreal & LVMH were responsible for 50% of the return of the CAC40. If we do get past this virus, there might be even more uncertainty and thus volatility in the event that the Fed is forced to move faster due to a return of growth and inflation getting out of control. Then the conditions exist for large cap growth stocks, already trading at extended valuations, to have their first down year in some time. Who will be the New Winners in that case? Likely more cyclical value plays such as banks and energy stocks.

Nowadays, though, there are some investors who want nothing to do with owning fossil fuel stocks. How then might they keep up? A move into financial stocks might make sense. Higher interest rates, something we will refer to as a move back into the Terrible Twos (in terms of yield on the US 10-year) might also present other problems. While the direction of interest rates may be clear (by all indications rates are headed in an upwardly direction) the pace at which they trace that path will be very important to market participants. Orderliness matters…a lot.

We mentioned energy. For those still willing to own energy stocks, will oil supply be a concern as demand stabilizes? Global oil has shrugged off the Omicron variant of COVID-19, while supply constraints hamper producers around the world. Those countries wealthy and powerful enough to possess strategic reserves released them in the fourth quarter. The result was a lower oil price, but pundits and futures prices both are predicting higher prices down the road, an outcome those who fret over the return of inflation fear most. Changes in the oil price are felt in real time as they impact the cost of travel and goods transportation costs so quickly.

We have to talk about China

China is and has been a very important part of the investment landscape for some time. Its significance has grown right along with the size of its economy, and it has emerged as the world's new superpower. But a funny thing happened along the way as it hit a bump last year. China's large-cap CSI 300 Index fell roughly 5% for the year. Hong Kong, home of numerous Chinese tech and other giants, saw its Hang Seng Index dive almost 15% in 2021. The MSCI China Index ended the year down 21%. China is so big that its poor returns last year caused the EM index to lag. Has the crash in Chinese markets brought us to the point where it is time to buy the dip? Can India replace China as the leader in Emerging Markets?

There seem to be more questions right now then there are answers. That seems fitting as we predict more volatility ahead. A portfolio manager's job is to look past the uncertainty and identify the things that are lasting in nature. We are on the record as liking quality stocks. Last year was a good year for quality stocks and a good year for us. This year, with all the uncertainty we expect looks like another good year for quality. In fact, most years are good years to own quality stocks until that trade gets too crowded. We will be on the lookout for valuations becoming overextended, but in the meantime, we will continue to practice our process: owning quality stocks which trade at a discount to their underlying fundamentals.