## The Return Of Volatility

After going dormant for a historical amount of time volatility finally returned to the stock market. **Our message the last year has been to enjoy the stock market climb and wait for volatility to return before considering changes to the portfolios. Now that volatility has returned what do we do from here?**

The obvious concern on everyone's mind is whether or not we are at the start of a serious correction. Of course, it is impossible to know the answer to that question until after the fact. Certainly a mild correction in the 5% to 10% range is possible, if not probable given the long stretch of time we've gone without one. However, it is very rare for financial markets to hit a peak and then go straight down arguing that any correction will be mild. Before almost **all major bear markets stocks tend to experience a topping process that can sometimes be measured in years.**

Although it's been absent for quite a long time the nature of volatility is that it tends to cluster, so we should expect more ups and downs, some of them probably dramatic, in the month and quarters ahead. Over the long term stocks clearly outperform other financial assets. Think of volatility as the price you have to pay to achieve the higher returns. While the near term action of the stock market is random we do believe the return of volatility signals that the recent above average returns will not continue. The biggest driver of long-term returns is starting valuations. When valuations are low, long-term returns are high; when valuations are high, long-term returns are low. While not in bubble territory valuations are above average suggesting more modest returns ahead.

However, it would be unwise to abandon stocks completely at this point. Equities will most likely still provide the best returns over time, and the last part of bull markets can be very lucrative. Plus the bond market looks even less attractive. Remember stocks are still up on the year while the bond market has lost money as interest rates have risen dramatically.

We will also be observant of the stock market laggards and leaders. The phenomenon of growth stocks outperforming value stocks has continued both during the melt-up phase and now during the selling. A handover of market leadership from growth to value would be a positive sign.

Nevertheless it is time for a change in strategy. If we are correct about the magnitude of long-term returns and more volatility, a more active approach to portfolio management best characterized as **selling stocks into strength and buying into weakness is warranted**. Therefore, expect more activity in the accounts.

*James Tillar, CFA and Steve Wenstrup*

OUTSIDE COMMENTARY

### Crestmont Research Earnings Trends- (excerpt)

As a result of recent tax reforms and business trends, earnings per share (EPS) is expected to surge 31% in 2018 and then continue higher in 2019.

The increase in EPS should provide strong contributions to the business and economic environments. However, EPS margins may then revert over the subsequent few years. The sudden surge in profits accelerates the business cycle as EPS outruns economic growth. High profit margins encourage competitive responses in the economy. Thus, after initial gains in EPS, profit margins are likely to revert toward or below normalized levels. After profits reach a trough, often during recessions, capitalistic forces will drive profits upward to again repeat the cycle.

The key point is that a capitalistic, market-driven economy prevents tax reform windfalls (or detriments) from becoming permanent. Ultimately, market forces drive overall returns on equity toward normalized levels (generally through sales prices).

As reflected in several updates, the economy is not a consistent driver of the stock market. Nonetheless, optimism about near-term prospects for the economy can provide a strong psychological boost to the market; this is likely to be a continued driver of the market into 2018.

The tailwind force of recent returns from the current cyclical trend seems to have distracted some investors away from the emerging headwind risks in the secular environment. The current high valuation and low volatility setting should encourage decisions away from cyclical excitement toward secular caution. The effect of which would be to emphasize risk management over investment optimism. Investors should remain exposed to the opportunities of further market gains while positioning with investments that seek to respond to market risks.

The information provided in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities listed herein will remain in an account's portfolio at the time you receive this report. It should not be assumed that any of the securities holdings listed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable. In addition we do necessarily agree with or endorse any outside commentary within this newsletter. If you have received this electronic transmission in error, please notify us by telephone (937) 428-9700 or by electronic mail: info@twadvisors.com. Outside Commentary www.CrestmontResearch.com.