Volatility <u>Has</u> Definitely Returned

Last quarter's letter ended with the following statement: "The stock market usually gives investors warnings before a major correction <u>in the form of higher volatility</u> so that will be the signal we'll look for before becoming more conservative". The signal was loud and clear in the first quarter of 2018 as volatility awoke from its slumber.

We believe the pertinent message of the return of volatility is 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.

Market skittishness was driven by several factors over the quarter. Investors became giddy after recent strong gains, always a contrary sign. Buyers committed a net $58 billion to mutual funds and exchange-traded funds that invest in global stocks over a four-week period in early January, the biggest inflows for any comparable stretch in records going back to 2002, according to Bank of America Merrill Lynch. The "Vix" index of US stock market volatility, known as Wall Street's "fear gauge", had its greatest percentage jump on record which triggered panic selling for a few weeks. **Most importantly from a long-term perspective the 10-year Treasury yield broke out of a longstanding range, rising to as high as 2.95% before settling back.**

Stocks rebounded for a couple of weeks after the initial sharp sell-off <u>prompting us to sell and trim some of our growth-oriented positions.</u> Shortly thereafter stocks had a second leg down as global economic data disappointed and fears of a trade war commenced. We are not preparing for a bear market **as corporate earnings remain strong** but hoping to take advantage of volatility. It is very rare for financial markets to hit a peak and then go straight down. Stocks tend to experience a topping process that can sometimes be measured in years before almost all major bear markets.

While trade issues may turn out to be nothing substantial they bear close scrutiny. Politicians worldwide are becoming more nativist, and as they do so, barriers to the free movement of capital, goods and services are likely to rise. Importantly because restrictions on trade have generally been easing since 1945, investors have no experience of a broad tariff dispute. Suffice to say increasing global trade disputes would not be kind to stock prices.

After a final few strong days the S&P 500 ended little changed down -0.7%. Although volatility returned, market leadership remained the same. Growth stocks, up 1.9%, once again outpaced Value, down -3.7%. **From our perspective a handover of market leadership from growth to value would be a positive sign and signal the bull market has further to run.**

Regardless, 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.**

James Tillar, CFA and Steve Wenstrup

OUTSIDE COMMENTARY

Cumberland Advisors

Dovish or Hawkish- 1st Press Conf.

FED Chairman Powell (excerpt)

Perhaps the most relevant aspect of Chairman Powell's press conference **was the fact that he emphasized that the pace of policy normalization would be gradual and data-dependent.** Furthermore, he stated that the FOMC would be flexible, that the risks to the forecasts were roughly balanced, and that there was considerable uncertainty as to whether there was, at present, a strong linkage between tight labor markets, wage increases, and inflation. He did not see signs of an incipient run-up in inflation that would put the Committee at risk of being behind the curve.

What has not gotten the attention that it deserves, however, is the curious pattern in the various components of the SEP forecasts. That pattern raises questions about how the FOMC sees the relationship between policy changes and their impact on growth and inflation dynamics. To illustrate, the table (not included) shows the median projections for the federal funds rate, GDP, unemployment, and inflation rates over the forecast horizon. Note that despite Powell's claim that the economy is showing strength, the median GDP growth estimate declines sequentially year by year and bottoms out at 1.8% in the intermediate term. This is an outcome consistent with less than 1% growth in the labor force and a 1.2% rate of increase in productivity and is not at all in line with the administration's goal of 3% growth.