The Return of Equity Market Volatility

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After an almost unprecedented period of record low equity market volatility that began in late 2016, equity markets have experienced a sharp reversal from record highs set in late January 2018. While it's somewhat difficult to identify a clear reason for this sudden pullback, excessive optimism relating to tax reform, the Federal Reserve continuing to unwind its balance sheet, rising interest rates and above average equity valuations are the likely culprits. More important, there are currently very few reasons to believe that a sudden slowdown in economic activity and corporate profitability growth is imminent.

Equities had an almost uninterrupted march upward in 2017 as market volatility was nearly non-existent and remained near record lows for most of the year. Examples of this low volatility included:

- The S&P 500 Index produced a positive return in every month of 2017 (something that had never happened before in a full calendar year).
- The S&P 500 Index did not fall by more than 2% in a single day all year, and had just eight days where the index was up or down more than 1%. This is the lowest number of such days since 1964.
- The Dow Jones Industrial Average Index set 71 new highs throughout 2017, the most new highs in a calendar year since 1910.

After an extended period of relative calm in the equity market, it is important to remember that periods of heightened market volatility are inevitable. In fact, the Dow Jones Industrial Average has experienced a 10% or more decline ("market correction") roughly once per year on average from 1900 to 2017 (source: Capital Research and Management Company).

As the severity and duration of equity market drawdowns is impossible to predict, it is important to remain fully invested, even during periods of falling equity prices. Market timing is an impractical exercise as no one can consistently identify market tops and bottoms. Ultimately, this behavior results in lower returns over a full market cycle. Further, it is not uncommon for the best days of equity market performance to quickly follow the worst. Simply remaining fully invested rather than missing the best days can help increase the probability of investors meeting their long-term risk and return objectives.