Understanding Recent Market Volatility

Informational commentary from Rothschild Asset Management Inc., the subadvisor to Pacific Funds℠ U.S. Equity Funds.

What Happened

After an extended benign period for stocks, volatility has raised its ugly head, sending equities sharply lower. In a matter of days, the S&P 500® index has fallen approximately 8% from its high. The decline gained steam on Friday, February 2, with the release of a U.S. Bureau of Labor Statistics (BLS) report revealing that average hourly earnings rose 2.9% year-over-year in January, the largest increase since the end of the recession in 2009. While the absolute magnitude of the rise was not astronomical, it was larger than expected, given that up until this point, the economy had added jobs for 87 consecutive months without a meaningful uptick in wages.

There is some evidence that automated trading may have increased the magnitude of the sell-off despite an absence of major economic news. By some estimates, quantitative trading accounts for as much as 90% of market volumes, so the unwinding of short-volatility positions may have magnified losses, particularly as the CBOE Volatility Index® (VIX®) jumped from low double-digits to a reading of 50. In addition, the recent synchronization of global growth may have proven a double-edged sword, as investors globally took profits in unison.

What It Means

Although market declines are not taken lightly, we believe that the fundamentals are still intact. Gross domestic product (GDP) growth remains solid, but not at overheated levels. This recent downturn is a very different event from the market decline in early 2016, when fears of a recession were in play. And while wage inflation bears watching, even labor markets may have some elasticity, as labor-participation rates remain approximately 3.5% below where they stood a decade ago, per the BLS.

Although corrections can elevate investors' vital signs, they can actually be healthy after extended run-ups in market indexes, as they rein in valuations and allow the market to consolidate its gains. We also have seen sudden corrections before, such as when Dow futures fell 800 points overnight following an unexpected Trump victory in the presidential election, only to rebound sharply when the market reopened.

Our Positioning Going Forward

Given the absence of a change in fundamentals, our approach is to stay the course.

It is also possible that recent declines could make certain stocks or sectors more attractive than others. According to FactSet, more than 80% of companies included in the S&P 500 index that have reported fourth-quarter results have beaten analysts' revenue expectations. While not baked into fourth-quarter 2017 results, it is expected that the tailwinds provided by tax cuts will boost earnings further going forward. Finally, after the recent decline, J.P. Morgan estimates that the S&P 500 index now trades at 16 times forward earnings. We remain constructive on the market as a whole and will continue to look for stocks with relatively attractive earnings and the potential to exceed expectations.

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Definitions

The **CBOE Volatility Index (VIX)** is a key measure of market expectations of near-term volatility conveyed by S&P 500 index stock-option prices.

The **S&P 500 index** is a market capitalization-weighted index of 500 widely held stocks often used as a proxy for the U.S. stock market

Disclosures

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