



February 12, 2018 | Scott Carmack (Portfolio Manager)

VOLATILITY IS BACK!

VOLATILITY SPIKES AS COMPLACENCY UNWINDS

Investors have been caught off-guard with the recent spike in volatility as the most successful strategy of the last decade, selling volatility, unwinds. The fall out has been a 10% correction in equity markets. We expect volatility to persist throughout the year as this shock works its way through the financial markets, however, value is emerging--particularly in late cycle sectors like commodities and financials. We expect a rotation from growth into value over the next twelve months, and do not see a recession in 2018.

that perform well in this environment (commodities and financials) and seek to limit duration in their fixed income portfolios. The most recent pull-back has provided investors with an excellent opportunity to readjust equity exposure to these sectors. And, as the short-treasury trade unwinds, investors will have an opportunity to pare back duration risk.

RATES RATES RATES

Many financial pundits have blamed increasing interest rates for the latest sell-off. While they provided the catalyst, it could have been any number of reasons. Speculative positioning was too bullish, and complacency meant that it was only a matter of time. Rates just provided the excuse. As we have pointed out numerous times, we believe the single biggest risk to equity valuations is rising rates. However, we are not at levels consistent with recession. Moreover, speculative short positioning in the rate markets leads us to believe that there will be a reprieve in longer-term rates in the near future. While volatility was the most crowded trade a month ago, shorting treasuries has quickly eclipsed that. We expect an unwind, and with it lower rates and a return to normal volatility levels. That being said, 3.03% on the ten-year and 3.24% on the thirty-year remain the line-in-the-sand. Breaches of those levels are possible, and sustained time above those levels may bring more pain to equity markets. Again, we suspect we will see lower rates before a breach of those important levels.

CONCLUSION

This is textbook late cycle action. The Federal Reserve is finding itself behind the curve, and wage growth and inflation will be 2018 themes. Investors should overweight sectors