Appleton's Thoughts on Recent Stock Market Volatility 2/6/2018

As we noted in our latest letter, 2017 was unusual in that stocks trended upwards in a tight range the entire year. Volatility, largely absent for fifteen straight months, returned to the stock market over the past two trading sessions. After closing at an all-time high on Friday, January 26th, the S&P 500 declined -3.8% the following week, and followed through with a -4% drop on Monday. The S&P 500 finished Monday down -0.9% for the year, nearly 8% off the recent all-time high-water mark.

In our view, there was no obvious fundamental catalyst for the decline. The most likely cause for the drastic change in sentiment was the fear of rising inflation, which was stoked by a higher than anticipated wage increase released on Friday morning. Algorithmic and computer-driven trading surely played a part and likely exacerbated the move down on Monday afternoon as systematic strategies involving volatility and momentum unwound. The team at Appleton believes that the fundamentals that have underpinned this long-term uptrend remain in place. The data we have studied suggests that the majority of global economies continue to improve simultaneously and that a recession in the U.S. is not in the foreseeable future. With that positive economic backdrop, domestic corporate earnings remain robust: results for the 4th quarter of 2017 are tracking to low-teens earnings growth, and estimates for 2018 continue to rise. Finally, with the market pulling back in the face of rising earnings estimates, valuation levels are becoming more attractive, and we are now seeing the forward P/E on the S&P 500 at a reasonable 16.9x.

During periods of volatility, it is helpful to remember that prices move much quicker than fundamentals. It is often said that the stock market rides the escalator up, but takes the elevator down. This current bout of volatility reminds us of the drop we experienced nearly two years ago during early February of 2016. Volatility spiked amid fears of a slowdown in Chinese economic growth, a drop in oil, and uncertainty over the future path of interest rates here in the U.S. Nothing changed in the positive fundamental outlook, but a crisis of investor confidence caused a relatively short lived -10% decline in the overall market. The market eventually found its footing and resumed its longer-term uptrend, returning over 40% since that time. We have no way of knowing with certainty where the market will inevitably find a bottom in the short term. We could see further selling and possibly test the 200-day average of 2,542 on the S&P 500, but we would look for support roughly around that level.

Pullbacks are ultimately healthy, and necessary, for future gains in the stock market. The team at Appleton believes that current levels will likely prove to be a better buying opportunity in the medium term than an opportunity to sell. An improving economic backdrop coupled with a strong corporate profit environment keep us constructive on equities going forward. As always, we believe in a balanced, long-term approach, and we will continue to monitor our clients' portfolio allocations as we look to stay the course.

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