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WHY SO VOLATILE?

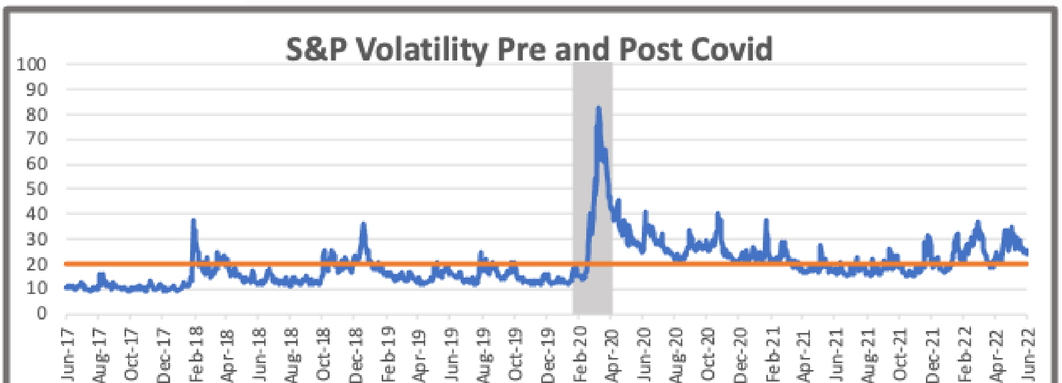
THE STATE OF THE MARKET TODAY

WHAT IS MARKET VOLATILITY?

Uncertainty drives volatility and, while investment professionals often discuss volatility, the definition is not always clear. In layman's terms, market volatility occurs when the daily price movement of a stock, bond, or other instrument is above the longer-term average. For instance, instead of a typical daily S&P move of +/-1%, a volatile market may increase or decrease by 2%, 3%, or more. As a result, an increase in volatility may drive investor losses.

VOLATILITY

The VIX chart below depicts the S&P volatility over the last 5 years. The five-year VIX average is 20, and since March 2020, the VIX has, on a daily basis, consistently exceeded the five-year average. In particular, the VIX has closed above 20 every trading day since April 5, 2022. According to the VIX, the risk to the downside has substantially increased, leaving ill-managed portfolios at potentially greater risk of losses.



Note: Gray area is recession period. S&P volatility is calculated using the CBOE Vix. Volatility is high when it is above the average line and low when below the line.

Source: St Louis Federal Reserve

When Covid hit the U.S., investment price swings increased due to uncertainty in the financial markets. Volatility occurs for numerous reasons, but essentially, the market can become volatile when market participants have a misperception of market expectations from one day to the next.

During the pandemic, investors initially lacked clarity on the financial health of consumers, municipal health, pricing of goods, and more. Once the Federal Reserve and U.S. Treasury took substantial measures to reduce risks, volatility attempted to revert to its five-year average but was unsuccessful. Since the re-opening of the economy, the post-pandemic world has grappled with the supply chain crisis, the Russia/Ukraine war, and rising inflation. Each of these, by themselves, is capable of increasing uncertainty and volatility.

Over the last two months, volatility has increased as investors have become increasingly focused on whether or not companies could successfully offload costs onto consumers while also maintaining revenue growth. The chart below illustrates the increased volatility of the S&P 500 over this period, with the market declining by 2.8% on five separate days (a move that usually only occurs 2 times per year). This is what we consider to be textbook volatility.

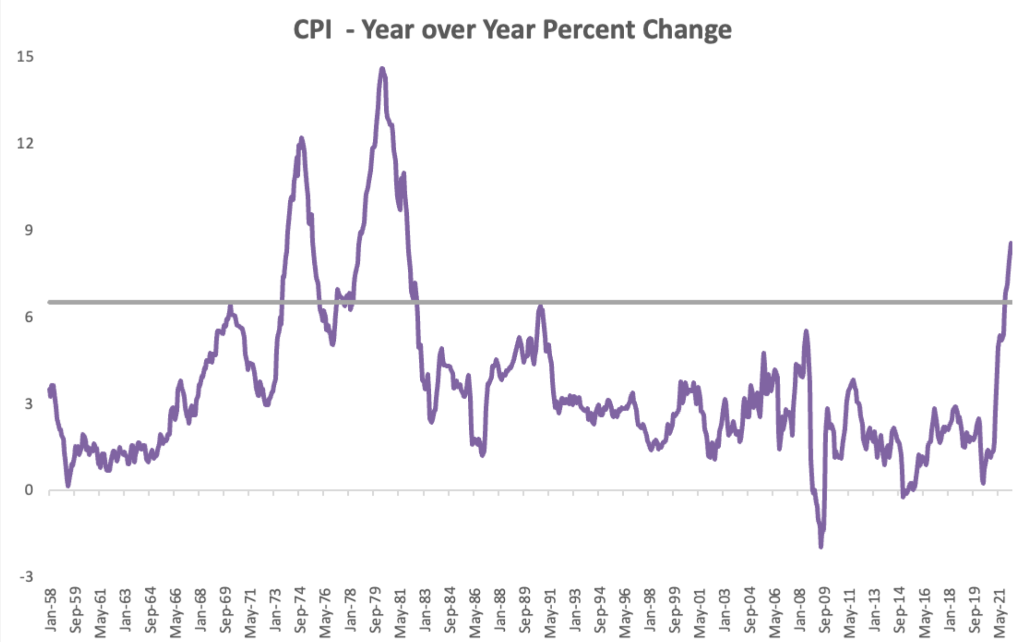
1 Year S&P Price and Volume Volatility

Note: Purple bars are price 3 std deviations from prior 1 year period.
Source: Bloomberg, LLP

WHAT IS DRIVING TODAY'S VOLATILITY?

We believe that three factors have led to the recent increase in volatility: Inflation, war, and uncertainty around corporate earnings.

The Federal Reserve's actions to support the economy during the pandemic were successful but resulted in an increase in available money that pushed inflation higher. The primary measure of inflation, the Consumer Price Index (CPI), began to rise in late 2021 and exceeded 8% in May of 2022, higher than the rate of inflation observed over the past 40 years. Rising inflation is forcing the Federal Reserve to take drastic measures to curtail price increases, but investors do not always agree on the extent of these efforts. Additionally, the outcome of rate hikes is not always clear. Thus, volatility increases because the market is divided on the degree of Federal Reserve tightening required and there is a lack of clarity on the longer-term impact.

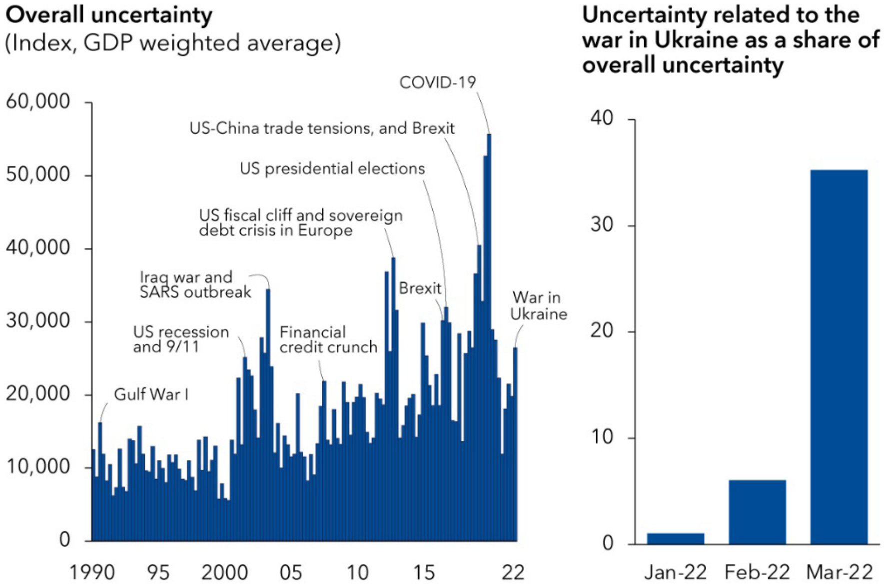


Note: Line is 6.5%
Source: St. Louis Federal Reserve

The second driver behind today's volatility is political tensions and war. Russia's invasion of Ukraine has led to food and energy shortages across Europe. Russia previously supplied approximately 2/3rds of Europe's energy needs in the form of natural gas, oil, and coal. Natural gas is also a significant component of mineral fertilizer and the reduction of available fertilizer has significantly impacted food prices. Higher food and energy prices increase the potential of Europe entering a deep recession and, in turn, this creates additional uncertainty for the U.S. and the global economy.

Fog of war

The World Uncertainty Index is climbing again as the invasion of Ukraine clouds the economic outlook.



Source: Ahir, Bloom, and Furceri (2022).
Note: The left chart is computed by counting the percent of the word "uncertain" (or its variant) in the Economist Intelligence Unit country reports. The index is rescaled by multiplying by 1,000,000. A higher number means higher uncertainty and vice versa. The right chart is computed by counting the percent of the word "uncertain" (or its variant) that appear near a word related to the war in Ukraine in the Economist Intelligence Unit country reports and is calculated as a percentage of overall uncertainty.

IMF

The third factor behind today's market volatility is the level of uncertainty surrounding corporate earnings. Inflation above the Federal Reserve's targeted 2% rate results in revenue, margin, and corporate earnings uncertainty. Additionally, the timing of when the Federal Reserve tames inflation with rate adjustments adds to corporate earnings uncertainty.

Also impacting corporate earnings has been a relatively new issue tied to supply chain stress. Driven by underinvestment in the supply chain infrastructure, outdated regulations, a limited supply of transportation chassis, warehouse storage issues, and wage issues across various sectors, the U.S. has experienced shortages of goods on the shelves. And if corporations don't have enough products available to sell, revenues take a hit. So, while the supply chain crisis has been growing for years, Covid and the Russian war accelerated it.

Food and energy prices continue to increase and drain U.S. household savings while curtailing near-term spending. Previously, CEOs stated consumers were willing to absorb higher prices, but recent earnings and declines in in-store sales have indicated that additional price increases may become difficult to pass along to the consumer, bringing into question future corporate earnings growth.

The composite of these factors has created uncertainty; the market does not like uncertainty. This translates into higher stock market risk, especially to the downside.

TOMORROW'S VOLATILITY

We believe the current market environment is likely to see continued uncertainty and thus, greater volatility for the foreseeable future. There are several factors at play, and each adds to the degree of economic uncertainty. The factors include:

1. Federal Reserve and Interest Rates
2. War
3. Energy and Food Prices
4. Supply Chain
5. Pandemic
6. Elections

The Federal Reserve is in the process of raising rates which is a negative for stocks and bonds, especially growth stocks and long-dated bonds. Expectations are for the Federal Reserve to raise rates at least another 150 basis points, which could put the Federal Funds Overnight-Funding Rate at approximately 2.5%. This is not high by historical standards, but it is a high water mark for the past few years. Current chatter indicates the Federal Reserve might pause in November, but again, this is uncertain.

The continued war in Ukraine could potentially spread, resulting in further damage. Putin has already indicated his desire to reunite parts of the former USSR, and Ukraine has refused to concede parts it has lost. Russia's victory or loss becomes somewhat irrelevant as existing sanctions are likely to remain long after the war, preventing Putin's removal. Companies and investors are not expected to move money back into Russia either, which creates greater political instability in one of the world's largest military powers.

Energy and food prices are always volatile, but current volatility and uncertainty remain difficult to foresee and can continue to affect inflation. Continued price increases in food and energy would continue to be problematic.

The supply chain crisis continues to slowly resolve itself, but a complete solution will ultimately require long-term structural changes. Companies have started to discuss moving production facilities from Asia to other areas of the globe and increasing the supply of goods for sale in their warehouses.

The pandemic is nearly over, or so it seems. But how the virus mutates and develops has yet to be determined and contributes to uncertainty.

As the U.S. moves into mid-term elections, political discord and a growing divide between the far right and the far left could weigh on the markets. Emotions often run high during elections, and 2022 has not disappointed so far. The 2022 and subsequent 2024 elections are likely to create additional volatility, particularly if one party dominates all three branches of government.

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INVESTOR EMOTIONS

During volatile periods, investors often go through several emotions: Anxiety, Fear, Panic, Depression, and FOMO (fear of missing out). Anxiety sets in as market swings begin, and investors become fearful but often don't react. Then, after some intense pain, panic sets in. Investors sell out of positions expecting to cut their losses and buy back when the market is poised to rebound. Studies have shown investors tend to buy back their shares at a higher price. Investors become reactionary instead of proactive.

5 THINGS TO DO ABOUT VOLATILITY

We believe that investing is about being proactive. Making decisions based solely on historical information is like trying to drive a car solely using the rear-view mirror. It works great until the road curves and you drive over a cliff.

We suggest that investors consistently do 5 things to help ensure their portfolio is healthy and prepared for market volatility.

1) Work With an Active Manager

We believe that an investment professional who takes an active management approach can potentially preserve capital, help identify opportunities during volatile markets, and help establish goals while also assisting in managing expectations. Investors should participate in an annual review with a financial services professional who considers changes in goals, asset allocation, and life circumstances.

2) Recognize Your Risk Tolerance:

Investors often believe they have the stomach to tolerate a high amount of risk until that risk comes home to roost. One question to ask yourself is: When do the losses create a breaking point for you that moves you to sell the positions and stop investing. Working with an investment professional can help you design a portfolio that focuses on managing risk and generating potential returns.

3) Tune out the Noise:

Individual investors often get caught up in the emotions and news headlines of investing. During market corrections and times of volatility, CNBC and Bloomberg are featured regularly on newscasts. An investment professional can help tune out what is just hype from what is truly important.

4) Remove Emotions from Investing:

Emotional investing is dangerous as it often leads to mistakes. Investing is about theory, math, finance, and understanding the myriad of economic figures. We believe that tuning out the headlines and working with a professional investment advisor are two great ways to avoid making emotional decisions.

5) Focus on your goals:

Review emergency funds, short-term goals, and long-term goals against your current savings. Develop realistic expectations and find what changes can be made to meet your goals. Repeat this process and review it on an annual basis.

Investing can be, at times, gut-wrenching, but it doesn't need to be. Volatility is an inherent part of the market, and with that, there are opportunities as well. But, like life, you have to plan for the opportunities and be ready when they present themselves. A regular plan and check-up with an investment advisor who is an active manager can help ensure your portfolio is prepared for volatility.

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737 N. Michigan Avenue, Suite 2120 • Chicago, IL 60611 • 312-337-1040 • www.ctsfinancialgroup.com
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