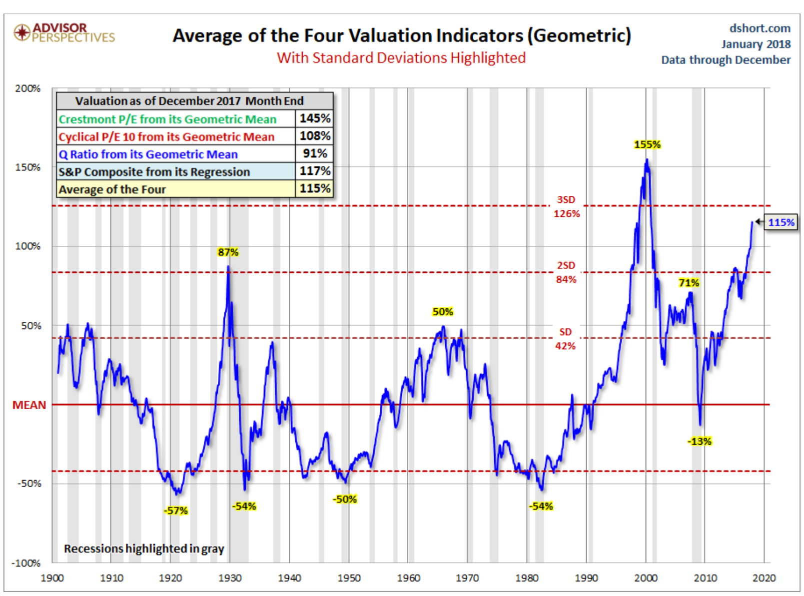
GLOBAL UPDATE

Volatility Update

This is a brief interim update in light of the volatility we've seen in the past few days.

I've discussed the return of volatility with clients for way too long now, as well as both stock and bond market valuations. The truth is that the situation, until the past few days, has been completely abnormal.

In past newsletters, I've discussed the fact that Central Banks, through the process of suppressing interest rates, have pushed people and institutions into holding more aggressive portfolio allocations than they should own. The term "Bernanke Put" was coined while Janet Yellen's predecessor, and head of the U.S. Fed, was working his magic during one of the multiple Quantitative Easing (Q.E.) programs. These were the money printing programs, and traders knew that the Bank would serve as a backstop to any significant market selloff in an effort to create market stability and promote economic growth.



Ultimately, years of low interest rates and suppressed volatility have pushed equity valuations to some of the highest levels in history (see chart - left). What we are witnessing now is a surfacing of the tension that has built up under the surface of market for a very long time. We believe this bout of volatility was first created by the velocity of interest rates increasing through the end of last week. While rates are still very low, the rate of change, as well as inflation prospects, spooked the market into believing that the Fed might have to act aggressively going forward. Today however (Monday, Feb 5th), rates were actually down, but the Volatility Index (VIX) soared by over 33%. This is a technical trade. Many institutional investors were lulled into complacency and pursued strategies that made money as volatility declined. It appears that we are witnessing the unwinding of of the "short volatility" trade. I would not be surprised if the selling pressure continued for a bit longer in waves as managers receive margin calls and are forced to sell positions.

Institutions made their deal with the devil on the volatility trade, and it seems many individual investors became enamored with the relentless rise in equities. Many were buying without concern for valuation. The (to use a common Wall Street term) Fear of Missing Out (FOMO) simply became too great. Many ignored the fact that valuations are high, investor sentiment had become too optimistic (a contrarian indicator), and other indicators we've discussed have been flashing red. Understanding that two days (at this point) does not make a trend, my hope is that the volatility we're beginning to see reminds people of that there are real risks that exist in the markets.

While recent tax cuts and lower regulations in certain industries are certainly beneficial to U.S. stocks, I believe the impact of these changes are somewhat small as compared to the effect that eight years of super low interest rates, and the decline of the US Dollar in the past year, have had on the market. I do expect interest rates to moderate shortly, but my concern is growing that a reversal in the US dollar (going from weakness to strength) may become a headwind for U.S. equity markets.

We've positioned a vast majority of our portfolios in strategies that are 1) flexible to adjust to the direction of the market, and are not required to hold stocks as markets decline; or 2) are in categories unrelated to the stock and bond market performance (managed futures for instance). We've significantly underweighted "core stock" exposure, as well as "core bond" exposure, and had written about the potential that both stocks and bonds decline in value at the same time. When we have purchased individual stocks, we've largely focused on areas of the world and sectors where those stocks have extremely cheap price to book values, good cash flow, low debt, and sustainable dividends. With many market sectors being so extremely overvalued, our feeling is that it's hard to fall out of bed if you're sleeping on the floor. We think valuations matter!

Volatility, such as we've just seen, rarely occurs as an isolated event. We welcome a return of some semblance of rationality. At least a healthy give and take would be fine. We've spent quite a long time preparing for a return of volatility, and look forward to some of the opportunities it may present.

As always, we welcome your calls and questions.

Brian Prichard & Your Team at 44 North Financial Partners


DJI - DJ Industrial Average, Weekly
Copyright, October 2017
Elliott Wave International
www.elliottwave.com
All *Four* One Bulls
DJIA Weekly, Range
22872.8
20000.0
15000.0
10000.0
(1)
A
B
C
(2)
(3)
B
A
C
(4)
4
Investors Intelligence
Advisors' Survey
Bull/Bear Ratio
4.2-to-1
27-year extreme
(since 1987)
4.0-to-1
.41-to-1
data courtesy of InvestorsIntelligence.com
5
4
3
2
1
2009 2010 2011 2012 2013 2014 2015 2016 2017
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Wed Oct 11 2017 15:27:23, CQG 15.9821