Is This the Beginning of the End? A Look at October 2018 Market Volatility

Presented by Steve Richardson, CFP®, CRPS®, CPA, President

Not for the first time, October was a difficult period for the stock market. With the drop seen over this past month, there is increasing fear that this is it—the big one that will take us back to the depths of 2008. Although that level of concern is certainly understandable, a closer look at the real economic and market situation around the world suggests that the volatility we are now seeing (and may well continue to see) is perfectly normal. Over time, this kind of turbulence is why stocks can yield the returns they do.

Still, how do we know whether this decline is normal and whether we're headed for another 2008? Is there a way to tell?

Is this decline normal?

Let's start with the easy question first. As of this writing (October 31, 2018), the S&P 500 was down about 7 percent from its peak. It has recovered somewhat from its bottom, when it was down about 10 percent. That seems like a big decline; by recent standards, it is. When we look back further, however, this drawdown remains normal.

Since 1980, for example, declines during a calendar year have ranged between 2 percent and 49 percent, with the average at just more than 14 percent. So, the October declines are well within the normal range. The market could drop another 7 percent (i.e., as much as we have already seen), and we'd still be at the average decline for a typical year.

Another way to answer this question is to see how often a decline of any given size occurs. Markets experience a 10-percent decline every year, on average. Even if things get worse—we are not there yet—this is about the fifth drop we've seen in the past five years. In that sense, we are once again right in line with the averages.

Are we headed for another 2008?

These facts are all well and good. Even if things are normal now, however, we need to think about how much worse this situation could get. There are no guarantees, of course. But if we look at past bear markets (defined as declines of 20 percent or more), we can make a few observations.

First, of 10 such events since 1929, 80 percent have occurred during a recession. The U.S. economy, despite some slowing trends, continues to grow; we are *not* in a recession. A growing economy tends to support market values and limit declines.

Second, 40 percent of past bear markets have come during times of rapidly rising commodity prices (e.g., the 1973 oil embargo). Rising prices tend to choke off economic activity and slam profit margins. Now, we have moderate commodity prices overall, which support economic growth and help profit margins, at least here in the U.S. These moderate prices, generally speaking, are not a problem.

Third, during 40 percent of past bear markets, the Federal Reserve has aggressively raised interest rates. While rates have been rising, they are still very low by historical standards. In fact, they are at the lower end of the range that prevailed from 2008 to 2011, after the crisis. They are also likely to stay low by historical standards for some time. As such, we certainly do not have the conditions that fuel a bear market. Despite the recent increases, low rates continue to benefit the economy, which has supported the market so far and will continue to do so.

Finally, half of the bear markets were born when market values were extreme. Current valuations are high by historical standards but low by the standards of the past five years. As we are seeing, an adjustment to lower valuations is painful. But it also means the risk of a further drop dissipates, which takes us back to the fact that periodic drawdowns are not only necessary but healthy.

Almost all bear markets have more than one of these traits; right now, we have (at most) one and really more like one-half of one. This doesn't mean that we won't see further declines. It does suggest that they are less likely—and would probably be short lived.

We can also look at recent history to evaluate how much trouble we might see if the situation were to worsen. Earlier this year, for example, markets pulled back by 10 percent, only to rebound and reach new highs. In early 2016, markets were also down more than 10 percent, only to bounce back to new highs. And we can go back further, to even worse pullbacks. In 2011, when Greece almost declared bankruptcy and broke up the European Union, we saw markets drop 19 percent. In 1998, during the Asian financial crisis, we also saw a pullback of 19 percent. Despite the headlines, our current economic situation is much more like early 2018 and 2016, and it is nowhere near as bad as either 1998 or 2011. Even with those declines, the annual return for each year wasn't disastrous. In 2011, the market ended flat; in 1998, it gained 27 percent.

What is the outlook for the rest of 2018?
Markets have recovered somewhat from October's midmonth lows, and the economic fundamentals remain good. While further volatility is possible, based on history, it does not seem likely that we will see a further massive and sustained decline that takes us back to 2008. Worst case, if the Chinese trade confrontation situation gets as bad as the Asian financial crisis or the Greek crisis, we could see additional damage. But we likely won't see anything worse than what occurred during those pullbacks.

With a growing economy, with strong employment and spending growth, and with moderate oil prices and interest rates, the U.S. is well positioned to ride out any storms—more so, in fact, than we were in 2011. Current conditions look much more like 2016 than 2011. As the island of stability in the world, we are also very attractive to foreign investors, as we can see by the strength of the dollar.

Look beyond the headlines
By understanding the history and economic context of today's turmoil, it is clear that markets may get worse in the short term. Still, the foundations remain solid, which should lessen the effect and duration of any further damage. Yes, the headlines are very scary, but things aren't that bad. So, we will be postponing the beginning of the end . . . again.

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For Registered Representatives: Steve Richardson is a financial consultant located at Potomac Financial Private Client Group. He offers securities as a Registered Representative of Commonwealth Financial Network®, Member FINRA/SIPC. Steve can be reached at 703.891.9960 or at steve@potomacfinancialpcg.com

Authored by Brad McMillan, CFA®, CAIA, MAI, managing principal, chief investment officer, at Commonwealth Financial Network®.