"If something cannot go on forever, it will stop." – Herbert Stein

After enjoying a 5% gain during January, the stock market has tumbled thus far in February, giving back all of its 2018 gains. Market volatility has surged, with the Dow Jones Industrial Average swinging as much as 1500 points in a day, raising fears as to whether the long bull market of the past nine years is at an end.

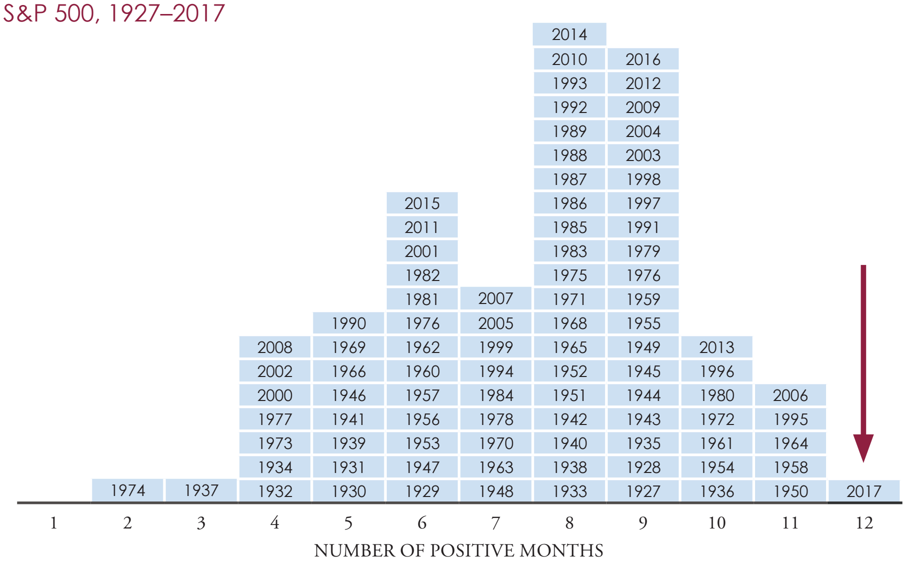
Before addressing this question directly, it is worthwhile to put recent market trends into context. 2017 was the first year in history that the S&P 500 posted a positive total return in every month of the year. In fact, through last month, the S&P 500 had posted 15 consecutive months of positive total returns, for a cumulative gain over that period of 36.2%. This streak of unusual stability in the market is also shown by the historical lows posted by the VIX Index[(1)] in 2017.

One of the best-performing trades last year was betting that market volatility would continue to decline. Such a trade is better described as a "speculation" rather than an "investment," but in any case, many hedge funds engaged in derivative investments designed to "short" volatility. The VelocityShares Daily Inverse VIX Short-Term ETN (say that fast three times) is an exchange-traded note that shorts volatility through futures contracts and is held by individual investors as well as presumably sophisticated institutions. While it was a winning speculation last year, this year it has been less so, as shown in the chart to the right (in fact it will be liquidated entirely later this month).

Expectations of continued consistently positive market monthly returns and continued declines in market volatility were unlikely to be realized,

MONTHLY POSITIVE RETURNS BY CALENDAR YEAR

S&P 500, 1927–2017



Data as of 12/31/17
Source: FactSet, Standard & Poor's

DAILY VALUE OF THE VELOCITYSHARES DAILY INVERSE VIX SHORT TERM ETN

12/1/10–2/8/18

Source: Bloomberg

and they haven't been. As stocks have declined and volatility has risen, a feedback loop has developed where selling has led to more selling. This has resulted in the huge daily swings in market averages that we've experienced over the past week.

While this volatility has understandably raised investor anxiety, it's done little if anything to dampen good market fundamentals. Thus far this year, roughly 80% of the companies in the S&P 500 that have reported 4Q17 earnings reported revenues that beat

(1)VIX is a market volatility index developed by the CBOE (Chicago Board Options Exchange).

Wall Street expectations, the highest percentage of positive surprises since 2008. Revenues for S&P 500 companies have now grown for six consecutive quarters, driven by higher consumer spending, low unemployment and strong manufacturing output. Importantly, current earnings reports do not reflect recent tax overhaul legislation, which reduces corporate tax rates from 35% to 21%. These lower tax rates will start to affect earnings and cash flow for companies later this year, adding further momentum to an already positive earnings environment.

Ironically, after years of a sub-par economic recovery that disappointed many investors, current signs of stronger growth are leading to investor concerns about the economy actually overheating, leading to higher interest rates that would choke off the recovery. While a spike in interest rates would clearly be a threat to the stock market, as long as future increases are moderate, we believe that stocks can likely withstand higher rates.

None of this is to suggest that the days of exceptionally low volatility that we experienced in 2017 are likely to return. The stock market will have occasional months and even years of negative returns in the future, just as it always has had in the past. Investors should have a long-term time horizon in order to withstand the inherent volatility of investing in stocks. However, those long-term investors should continue to benefit from stock investments in the years ahead.

DISCLOSURES

Performance

S&P Data

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