Strategy Monthly

Volatility Is Not on Vacation

August 24, 2015

One of my first bosses at Brown Brothers Harriman warned me of the dangers of taking vacations in August. In spite of the fact that most of the world finds time to get away, interesting things seem to happen during the last unofficial month of summer, from the resignation of presidents (1974), to the launch of wars in the Middle East (1990), currency crises in Russia and the Far East (1998), and the unprecedented downgrade of American debt ratings (2011). Last week's stock market volatility pales in comparison to these weightier historical developments, but the market swoon brought the market into negative territory for the year to date, and that warrants a comment.

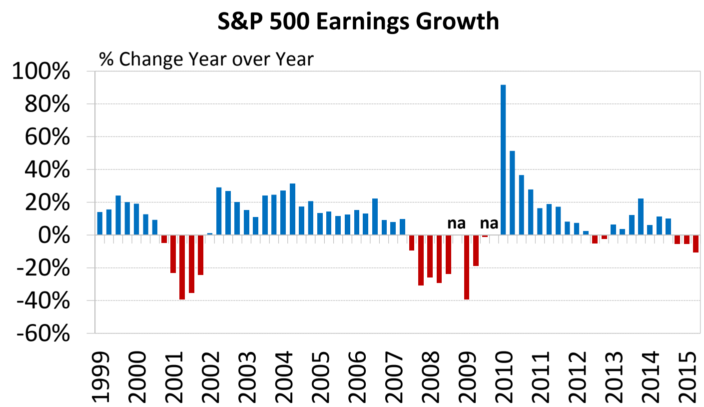
The S&P 500 dropped 120 points last week – mostly on Thursday and Friday – bringing market returns to -6% for the month and -3% for the year to date (through August 21). Developed markets around the world have performed similarly, while emerging markets have fared worse, dropping almost 10% so far this month and 13% since the beginning of the year. Traditional safe havens are acting their part. The yield on the 10-year government bond dropped from 2.18% at the beginning of the month to 2.04% last Friday, and even gold has recovered from its recent slump.

The airwaves and newspapers are full of market observers trying to answer the question "why?," and there are at least as many explanations as there are explainers. From a Chinese slowdown to an imminent Fed rate hike, from U.S. dollar strength to the relaxation of the Chinese currency peg, it is a target rich environment for those seeking reasons for the market decline. We believe that the search for exogenous catalysts is misplaced, and that the real reason for market volatility is endogenous. That is, the rise in volatility says more about the internal state of markets than it does about external forces.

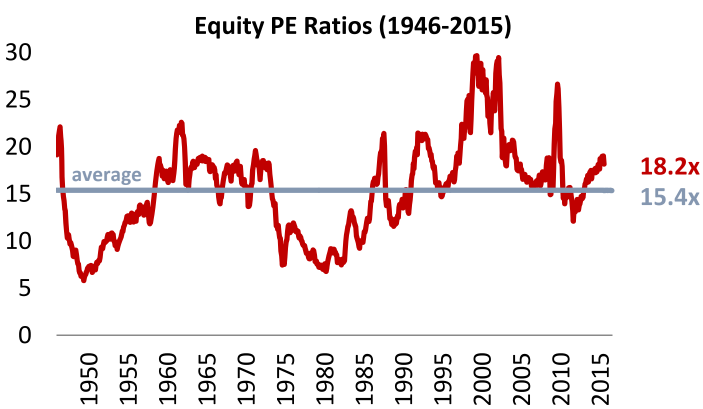
In making this observation we draw a lesson from the world of material sciences and the idea of critical state theory. This theory explains how the internal strength of a system can weaken until even the smallest additional outside force causes an outsized shift in the structure of the system. As an example, consider a pile of sand that is built by dropping one grain at a time onto the same spot. Over time a predictable pile shape emerges, but at some point one additional grain of sand – indistinguishable from those that have preceded it – causes the pile to shift. Whereas one could attribute that effect to the last grain of sand added to the pile (the proverbial straw that broke the camel's back), in reality the cause of the shift is the critical state of the pile itself.

Most market commentators over the past week have sought to blame grains of sand rather than the state of the market itself. It is far more instructive to consider what internal factors might be exaggerating market price volatility.

1. **Earnings growth**. Earnings, whether defined in accounting or cash terms, are the fuel of the equity market. Remember the old adage that "in the short run the market is a voting machine, whereas in the long run it is a weighing machine." Earnings are what the market "weighs," and the fuel is running thin. In the second quarter of 2015 the aggregate operating profit of the S&P 500 dropped by close to 11% year over year, the third consecutive quarter of decline. Most of that decline was due to the collapse of energy prices and the subsequent impact on the earnings of companies in that sector, but in this seventh year of an economic cycle, companies throughout the market are finding it hard to grow their earnings when the easy benefits of cost cutting and margin expansion are behind us.



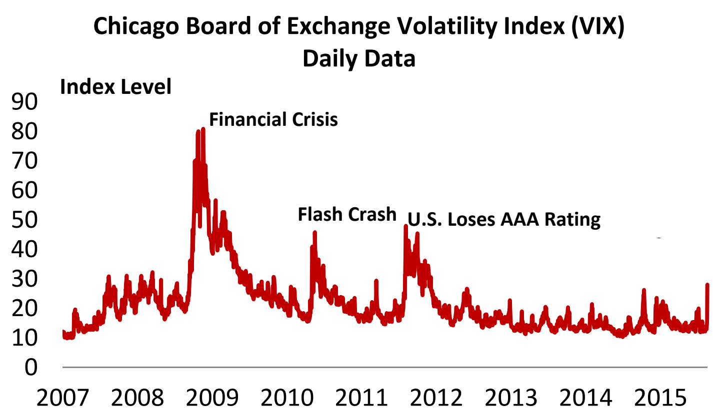
As of June 30, 2015.
Source: Standard and Poors, BBH Analysis.



As of August 21, 2015.
Sources: Standard and Poor's, Robert Shiller, BBH Analysis.

2. **Valuations**. Markets can move higher in spite of weak earnings if investors are willing to pay more and more for each dollar of earnings on offer. Rising valuations can rescue the market from poor corporate profits, but valuation levels at present offer precious little support for market prices. At 18.2 times trailing earnings (even after last week's decline), the valuation of the market is by no means at bubble levels, but versus a post-World War Two average of 15.4 times, the market is at least fully valued, and perhaps even slightly overvalued.

3. **Sentiment**. Poor (i.e., bearish) sentiment bodes well for the market, as even the slightest improvement in opinions about external conditions can lead to buying. Conversely, too much optimism indicates that the market is, in the well-worn phrase, "priced for perfection." Sentiment is clearly a subjective concept, but measures such as the Chicago Board of Exchange Volatility Index (the VIX) provide some quantification. The VIX set a new low for the year (complacency set a new high) of 11.95 on July 17 before jumping over 15 points last week alone to set a new high for the year of 28.03.



As of August 21, 2015.
Sources: Chicago Board of Exchange, BBH Analysis.

None of this analysis concerns the timing of a Fed rate hike, currency movements, geopolitics, etc. These are observations about the internal state of the market, not about the limitless exogenous forces that act on the market. The combination of waning earnings growth, high valuations and (until recently) rampant complacency leads us to conclude that the sort of volatility we saw last week is likely to recur. Note that volatility moves in two directions, and the "critical state" of the market can lead to exaggerated moves in either direction. So this does not necessarily spell the end of the bull market, just more volatile days like we experienced last week.

Throughout this commentary we have used the word "volatility" in relation to price. Price is a wonderful concept: it has the triple advantage of availability, transparency and frequency. Anyone with an internet connection can access the price of a stock, on which we would all agree, and which is updated constantly throughout the trading day. Unfortunately, those advantages are accompanied by the significant disadvantage of volatility. Value, on the other hand, possesses the opposite characteristics. It can't be determined easily, and investors often disagree on the value of a company. Yet value is far more durable than price. The price of corporate America – as measured by the S&P 500 index – has dropped 6% since the beginning of August. Do you think that the value of corporate America has dropped similarly?

Investors who appreciate these distinctions can make price volatility their friend instead of their enemy by focusing on the value of companies and their securities, and allowing price volatility to present the opportunity to acquire that value at an appropriate margin of safety[1]. This is an exercise far easier said than done, and requires patience, discipline and a willingness to be contrarian. Yet the search for investors who invest according to these principles drives our effort to construct portfolios for our clients that will enable the preservation and growth of their wealth over the long run.

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[1] Margin of safety: When a security meets our investment criteria and is trading at meaningful discount between its market price and our estimate of its intrinsic value.

PB-2017-06-07-1423