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Market Volatility Could Mean Market Opportunity

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After a historically difficult first quarter for risk assets, investors have gotten little reprieve so far in the second quarter. As we noted in April's Monthly Market Pulse, the primary culprit has been, and continues to be, interest rates. The rapid increase in rates year to date has been underpinned by historically high inflation and mounting expectations for the Federal Reserve to move aggressively to tame it (which it commenced at its March monetary policy meeting).

In the past, investors counted on the negative correlation[1] between stocks and bonds to help mitigate the negative impacts on their portfolio. In other words, when one asset class, such as stocks, declines, bonds are expected to perform relatively well and offset at least part of the loss. Recently, that has not been happening, and investors are understandably nervous. Below we explore the situation a little more in depth and consider some of the key metrics likely to drive asset prices over the balance of the year and into 2023.

Some Perspective

First, you may be wondering why stocks and bonds are both falling if they historically move in opposite directions. Generally speaking, rising rates are bad for both asset classes. Increasing rates drive down the prices of existing bonds that were issued with coupon rates below now-prevailing rates so that the expected total return aligns with newly issued (comparable) bonds. Stock prices tend to fall for a few different reasons. One is that higher interest rates make bonds more attractive, which reduces demand for stocks and causes prices to fall, all else equal. Another has to do with the means by which equity analysts calculate the fair value of a company's stock. A common approach is to estimate a company's future cash flows — whether it's earnings, dividends, free cash flow, or another metric — and use a discount rate to determine their present value. A higher discount rate translates into a lower present value, again all else equal. Higher rates also increase borrowing costs and may create a drag on corporate earnings and economic activity (although the impact here is not immediate).

Another aspect to consider is the speed and extent of the rate increases. More gradual, less dramatic increases are better incorporated into asset prices and corporate budgets. In contrast, the rapid and significant increase we've experienced year to date has triggered above-average volatility.

For perspective about the unusual scenario of bonds underperforming stocks in a quarter during which stocks' performance was negative, consider that since 1976 there have only been six quarters (out of 185) in which both the U.S. Aggregate Bond Index (bonds) and S&P 500 Index[2] (stocks) both posted negative returns and bonds fared worse than stocks (Figure 1). Negative quarterly returns for both stocks and bonds in the same quarter is also uncommon, happening just 10% of the time. Halfway through the second quarter, both indexes are firmly in negative territory. Consecutive quarterly declines for both indexes at the same time have never happened, but right now we appear poised to make history in that regard.

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[1] Measures the degree to which two assets move together at the same time

[2] Price return

Figure 1

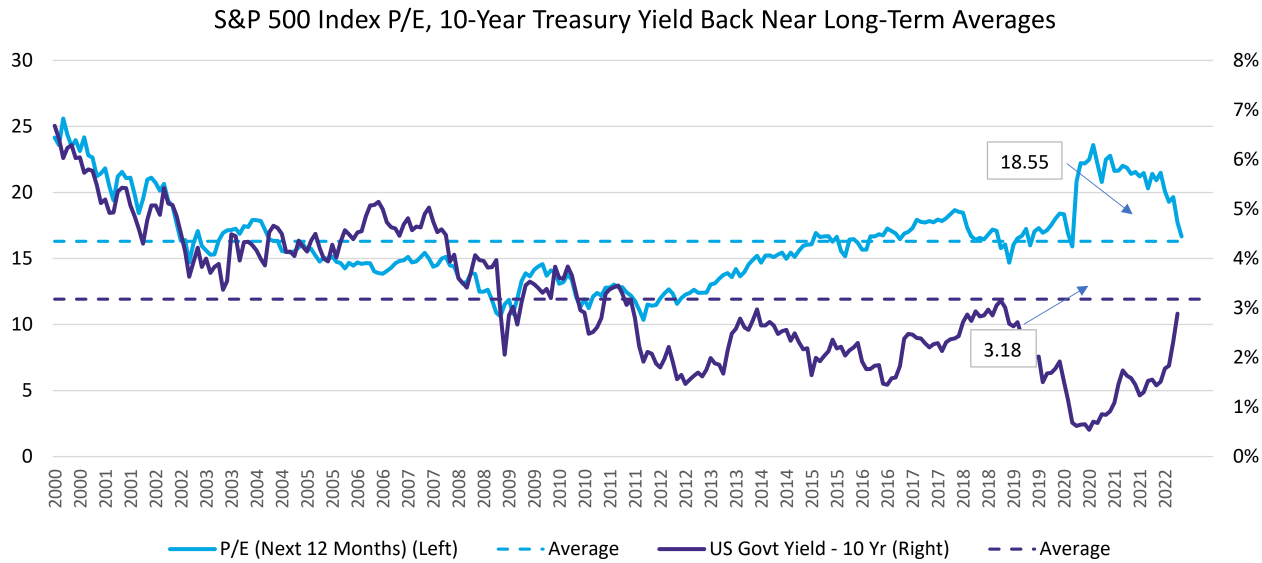
	Instances (Single Quarter)	% of Total	Instances (Consecutive Quarters)	% of Total
Stocks and Bonds Negative	19	10%	4	2%
Stocks and Bonds Negative, Bonds More Negative	6	3%	0	0%

Source: FactSet, Choreo as of 3/31/2022

Getting Back to Normal

Short-term gyrations in stock prices can sometimes be the result of irrational behavior, but over the long term, earnings determine the value of stocks. As shown in Figure 2 below, the price-to-earnings (P/E) ratio for the S&P 500 Index has come in line with long-term averages after trading at a significant premium for much of the last five years. And after dramatically rising year to date, the yield on the 10-year Treasury Note is also hovering around its long-term average.

Figure 2



The 10-year Treasury yield is commonly used in financial modeling to help determine the present value of a company's future earnings, and therefore what the analyst believes is the fair price of the company's stock today. Accordingly, if long-term Treasury yields remain near current levels on average, and earnings grow roughly 10% over the next 12 months3, the index would likely struggle to break even this calendar year, even when dividends are considered.

That is certainly not good news, but there are scenarios that could see stocks move back into positive territory by year's end and reasons to maintain one's disciplined investment plan even if that doesn't happen:

1. Earnings growth rates tend to trend higher throughout the year, so we could see results in excess of current forecasts if historical patterns hold.
2. Though not our base case, valuation multiples could increase, which would mean investors show a willingness to pay more for each dollar of earnings. In other words, stock prices would increase faster than earnings, a scenario that played out over much of the last decade.

[3] Source: S&P Dow Jones, Choreo as of 5/12/2022 . Past performance is not a guarantee of future results and investors may experience a loss.

3. Interest rates could resume their downward trend. Several different factors (or a combination thereof) could trigger a reversal of the upward trend we have experienced year to date, including a faster-than-expected deceleration in inflation and slower-than-expected monetary tightening by the Federal Reserve.
4. For prudent long-term investors, a dollar-cost-average approach helps turn volatility into opportunity. Positions purchased near current levels could generate attractive returns over the balance of the year, and/or help to mitigate year-to-date losses in existing positions.

Conclusion

There are many variables both stocks and bonds must navigate over the balance of the year and beyond: inflation, interest rates, the Fed's ongoing attempts to temper the former by manipulating the latter, and corporate earnings resilience, to name a few. We expect above-average volatility for the foreseeable future as investors continue to assess the dynamic landscape and recalibrate asset prices accordingly. Consequently, we could very well experience further equity price declines, but long-term investors may be best served with a dollar-cost-average approach that could help to turn volatility into opportunity.