# Portfolio Watch

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# THE RETURN OF VOLATILITY

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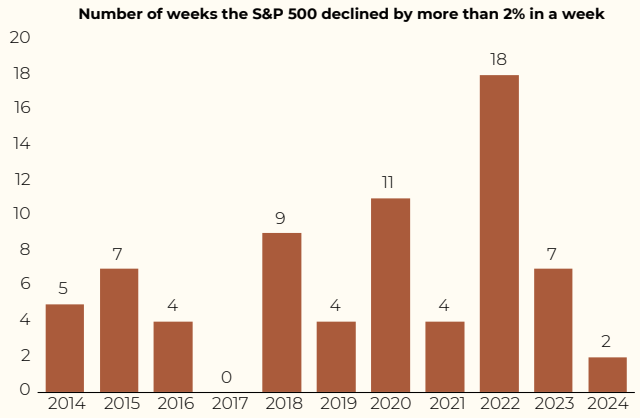
Last week was somewhat of an anomaly in recent market history. The volatility index surged to levels last seen in March 2023 during the US regional banking crisis. This was only the second time in 2024 that the S&P 500 Index dropped by more than 2% in a single week. The last time we went this far into the year with only one 2% weekly decline was in 2017. Long-term investors usually ignore such market trivia, and rightfully so. However, it is important to note that we have experienced very strong markets with very little volatility over the past 18 months. And while this might have felt like a comfortable ride, it is certainly not the norm for equity markets.

## NARRATIVES DRIVE MARKETS

The last significant market downturn occurred in the third quarter of 2022, when the S&P 500 fell by about 17%. Since then, two main themes have driven the market. The first is the transformative impact of artificial intelligence (AI) on economies and businesses, with expectations of increased productivity, faster economic growth and higher corporate earnings, particularly for large tech companies. The second theme is the hope that the US Federal Reserve will achieve a "soft-landing" of the economy by lowering inflation with higher rates while avoiding a recession. Until recently, this seemed to be unfolding quite smoothly, with the S&P 500 rising by 49% since October 2022.

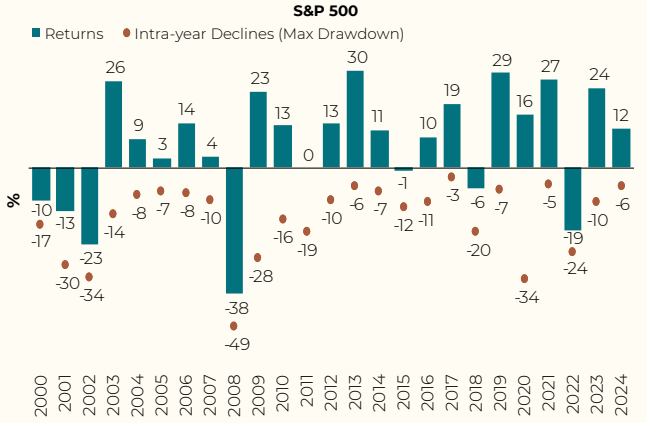
However, in the last few weeks, market jitters have emerged as several major tech companies reported earnings and announced increased capital expenditures related to AI. Critics argue that there is little clarity on when these AI investments will translate into tangible earnings, causing notable share price declines for these companies. Additionally, recent economic data has raised concerns. The latest US manufacturing and unemployment figures suggest that the economy may be slowing faster than the Fed anticipated, prompting fears that the Fed may have delayed rate cuts too long, potentially leading to a recession.

Graph 1: Calm markets




Sources: Bloomberg; Private Clients Research

Graph 2: Intra-year declines are the norm




Sources: Datastream; Private Clients Research

## VALUATION NUANCES

We believe that this latest growth scare and market jitters are part and parcel of long-term investing. Market narratives, even credible ones such as AI, often come with a degree of exuberance. During these periods, valuations can expand and become unreasonable. Some market sectors had begun to appear frothy. The tech-heavy Nasdaq Index, for example, has dropped over 10% from its recent highs and entered "correction" territory. Given that a handful of tech companies have driven most returns in market cap-weighted indices, it is unsurprising that this sector of the market has seen the most significant declines.

In order to understand the current market dynamics, the nuances in valuations must be considered. While headline valuation multiples for indices like the S&P 500 may seem expensive, the average company on the index trades at a reasonable valuation. This is evident in the forward price-earnings (PE) ratio difference between the market cap-weighted S&P 500 Index (22.3 times PE) and the equally weighted S&P 500 Index (18.1 times PE). Beyond a few high-performing companies, sectors such as Consumer Staples, Discretionary and Industrials trade at reasonable valuations, comparable to levels from a year ago.

## WHERE TO FROM HERE?

In the lead up to the Fed's September meeting, investors are wondering whether a recession is imminent, whether the Fed will achieve a "soft-landing", and how much rates will be cut by for the remainder of the year. While these are all intriguing questions that can move markets in any given week, long-term investors should not fixate on them. A balanced portfolio with defensive companies will benefit in such an environment. Although most defensive companies have lagged due to a few large-cap shares driving overall returns, they have been more resilient during recent market weakness.

Furthermore, during times of market volatility, investors need to be wary of trying to time the market. Legendary investor Peter Lynch noted: "Far more money has been lost by investors in preparing for corrections, or anticipating corrections, than has been lost in the corrections themselves". From January 2004 to January 2024, missing the S&P 500's ten best days resulted in a compound annual return of 5.6% compared to 9.8% for those who simply remained fully invested over the period.

While the return of volatility after a calm period may feel uncomfortable, the reality is that calm markets are historically the anomaly. Corrections and drawdowns are part of investing and are ultimately the price investors must pay for earning returns above the risk-free rate. What remains important in this environment is to stay invested in well-diversified, high-quality companies that are led by strong management teams. These are the companies we hold across our client portfolios.

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