BERNSTEIN

# RISK FINALLY RETURNS

**After an unusually long period of steady positive performance and no dips of even 5%, volatility came roaring to life in early February. The speed and magnitude of this awakening caught investors unawares and ignited a fear that prolonged market losses were on the horizon. Selling took hold. Now as the markets have settled a bit from the early month turbulence, investors are left wondering what's in store for the near term.**

## A CRASH COURSE

2017 was a year of tranquil markets and positive returns. Nearly 80% of S&P 500 companies delivered positive returns for the year. 2018 began where 2017 left off; the S&P 500 enjoyed the best January performance since 1997, capping off a string of 15 months of positive performance, a market feat never seen before. Coinciding with the positive returns was an environment that was abnormally calm. Volatility was extremely low in 2017, resulting in a Sharpe ratio for the S&P 500 that was in the first percentile, one of the best on record. Additionally, the market rose for 83 weeks without a pullback of even 5%, and more than 100 weeks without a larger, 10% correction (Display 1). But that all came to a halt during the first few days of February. US stocks declined by over 10% and volatility more than doubled as the VIX went from 17 to almost 40 in a single day.

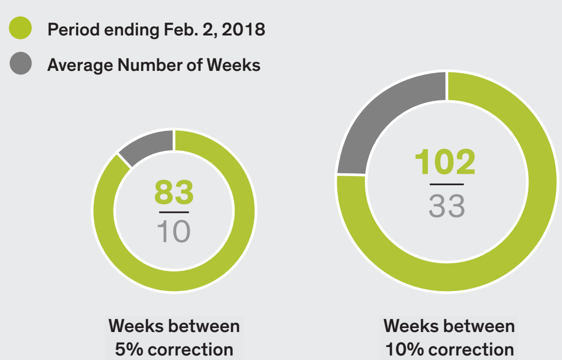
## INFLATION AS A CHANGE CATALYST

The sell-off was triggered by fears of rising inflation stemming from a stronger than expected January labor report and confirmed by the core CPI reading (Display 2). These data rose more than expected, solidifying the market's concern that inflationary pressures are building in the economy. But this mounting inflation is consistent with an economy operating at capacity.

Display 1

### TIME BETWEEN MARKET CORRECTIONS

S&P 500 (since 1928)

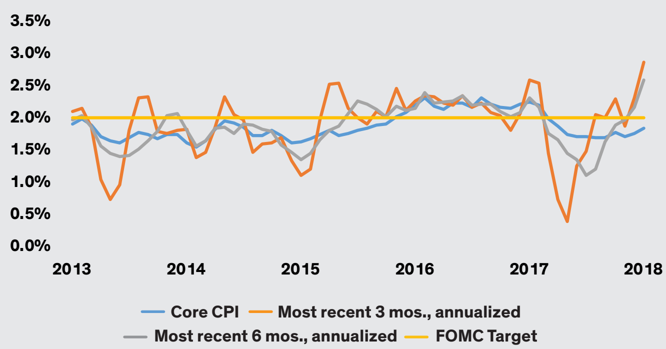



**Past performance is not necessarily indicative of future results.**
**There is no guarantee that any estimates or forecasts will be realized.**
As of February 2, 2018
Source: S&P and AB

Some of these reported data may be artifically high, such as January's wage growth, which may be exaggerated by one-time bonuses, an offshoot of the tax legislation, but we expect the trend is likely to persist. Rising wages together with already robust growth will force firms to pass higher costs on to consumers. So pricing pressure is likely to continue, but we expect the rise in inflation to be more gradual than the sharp increase reported for January. However, that's not all.

Display 2

### CORE CONSUMER PRICE INDEX




The market is also concerned that rising inflation will trigger a more aggressive Fed. We expect rates will rise this year. Although we forecast four Fed rate hikes in 2018, a prediction the market is moving towards, we believe rates are still low enough that an increase should not derail the equity market. Strong fundamentals—low unemployment levels, double-digit corporate earnings growth, and robust manufacturing reports—should continue to support markets ahead. We believe these factors illuminate a solid economic framework, and rising rates will not create a major headwind for growth. While these fundamentals argue for investors to stay invested and not try to time the market around volatile moves, there is a more compelling rationale for maintaining equity market exposure during tumultuous times. When markets decline, they seldom stay down for long.

## NOT A SURPRISE

The sell-off and related volatility were not unexpected; in fact, history tells us they were overdue. As unsettling as they are, market corrections are somewhat common. During the last 37 years, US equities were hit by a peak-to-trough decline of at least 10% in 20 of those years (Display 4). Despite these corrections, stocks posted negative returns in only six of those 20 years; the other 14, they were positive. And when they do decline, stocks don't stay down for long. Historically, after a decline of 10%, it takes just 10 weeks to recover and surpass the prior level.

## STAY VIGILANT

We know markets can change rapidly and complacency can catch investors unawares. We continue to monitor the markets, watching for several potential headwinds, notably tightening of financial conditions such as wider credit spreads and related signs of contagions into other asset classes. We are also following monetary policymaker language regarding their role in supporting markets and providing liquidity, or lack thereof. Finally we are watching for a rapid rise in interest rates which could surprise the market.

## CORRECTIONS = OPPORTUNITY

It's not easy to stay invested during market turmoil, but history shows that market timing rarely works and dips do not last long before markets return to growth. Although it might sound counterintuitive, market corrections often offer the opportunity to capitalize on market overreactions. Market turbulence opens the door to take advantage of lower valuations by tactically moving to different opportunities. These tactical moves require an active manager who can identify well-managed companies with sustainable margins driven by solid business models. And it is often during these times that strong companies pull away from weaker ones, a distinction that creates an opportunity.

**Display 3**

### POSITIVE RETURN STREAK COMES TO AN END

| Stocks | Feb 2018 | YTD |
|---|---|---|
| US | (3.7)% | 1.8% |
| Int'l Developed Markets | (4.5) | 0.3 |
| Emerging Markets | (4.6) | 3.3 |
| **Bonds** | | |
| Municipal | (0.2)% | (0.7)% |
| Taxable | (0.9) | (2.1) |
| **Alternatives** | | |
| Hedge Funds | 2.2%* | 2.2%* |
| Commodities | (6.8) | (2.2) |
| Real Estate | (6.7) | (6.7) |

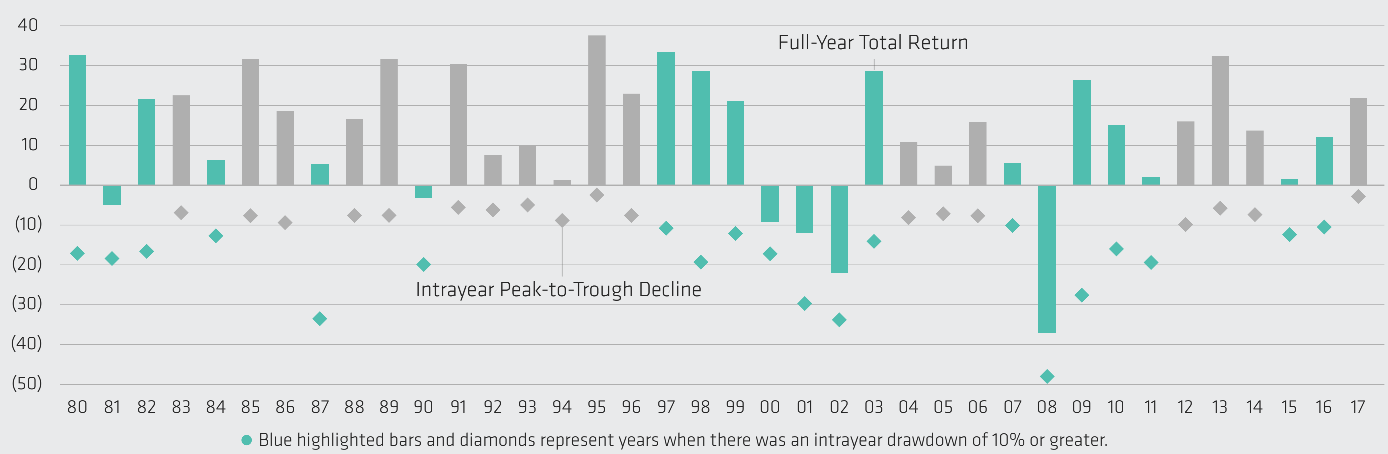
**Past performance is not necessarily indicative of future results.**
**There is no guarantee that any estimates or forecasts will be realized.**
US stocks are represented by the S&P 500 Index; international developed-market stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of developed markets in Europe, Australasia, and the Far East; emerging-market stocks by the MSCI Emerging Markets Index; municipal bonds by the Lipper Short/Intermediate Blended Municipal Fund Average; taxable bonds by the Bloomberg Barclays US Aggregate Bond Index; hedge funds by the Hedge Fund Research Inc.'s (HFRI) Fund of Funds Composite Index; commodities by the MSCI ACWI Commodity Producers Index; global real estate by the FTSE EPRA/NAREIT Developed Index. An investor cannot invest in an index. These figures do not reflect the deduction of management fees and other expenses an investor would incur when investing in a fund or separately managed portfolio. See "Information About MSCI" at the end of this report.

*As of January 31, 2018
Source: Bloomberg Barclays, FTSE, HFRI, Lipper, MSCI, S&P, and AB

**Display 4**

### STOCKS USUALLY REBOUND AFTER LARGE INTRAYEAR DECLINES

S&P 500 Total Return (Percent) by Calendar Year

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**There is no guarantee that any estimates or forecasts will be realized.**
As of December 31, 2017
Source: Bloomberg and S&P

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