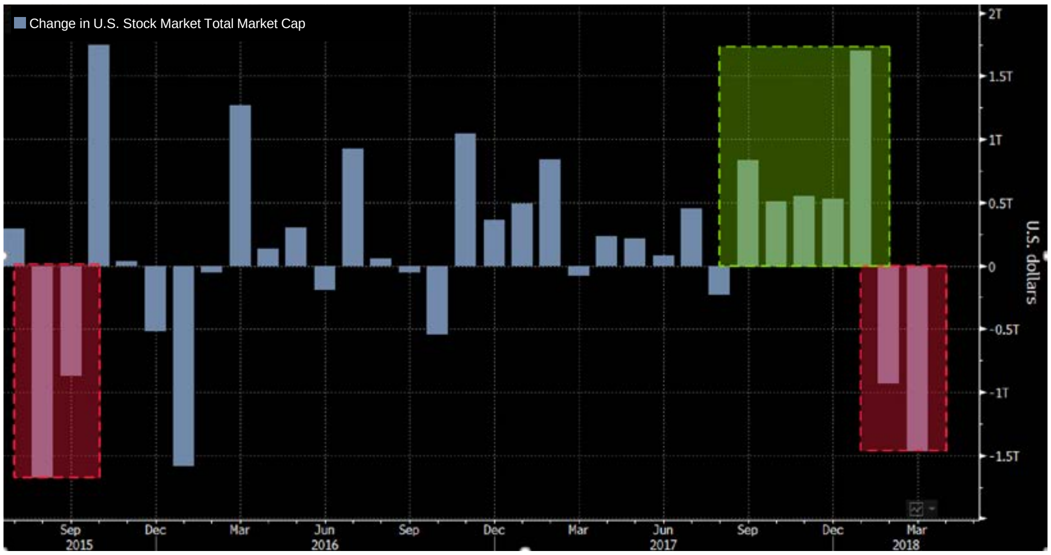
Market Commentary | April 2018
As of March 31, 2018

Q1 2018: How Risk and Volatility Are Different

After a pronounced period of calm, the broader equity market may have finally exhausted itself. Following 9 consecutive positive quarters, the S&P 500 Index was negative in the first quarter (Q1) of 2018. The last quarterly loss was in Q3 2015, when the S&P 500 Index was down -6.44%. While Q1 2018 ended with the index down only -0.76%, investors experienced a much more volatile ride. The year began with investors appearing to be in a buying frenzy, pushing the S&P 500 Index higher 7.55% by mid-January. Then came February. As prices spiraled lower fear set in, triggering a spike in volatility and ultimately moving equity markets into a technical correction. This was a reminder to all investors that risk is always present and can strike without a moment's notice. From the January 26th peak through the end of the quarter, the total market cap of the U.S. stock market shrunk by approximately $2.3 trillion.

Good Things Don't Last Forever: Change in U.S. Stock Market Total Market Cap



Sources: Bloomberg, SFG. Data as of 3/31/18. For illustration purposes only. U.S. stock market represents all publicly listed stocks traded on a U.S. exchange. T refers to trillion. For additional information please see disclosures at the end of this commentary.

The S&P 500 Index Entered a Correction Period for the First Time in 2 years

A "correction" is a term typically used by market participants to describe when prices drop at least 10%. Concern of changing expectations by the Federal Reserve regarding rate hikes quickly moved to amplified fears on geopolitical risks, President Trump's remarks on technology firms and global trade tensions. As always, panic in the market is accompanied by doses of narratives as investors attempt to identify reasons to stay invested or sell. The result may have been a "sell first, ask questions later" mentality. Ironically, fundamental data remained strong as the U.S. economy continued to expand and unemployment remained low. This mostly led to a technically driven market where different price levels became more relevant, with the potential to either make or break market movements. The selloff seemed to slow as the price of the S&P 500 Index reached its technical support (a support is a level where market participants expect more buyers) at its 200-day moving average. The pattern looked similar to the last two technical corrections in 2015 and 2016 where the market made a "W" shape.

Market Technicals Taking Over: S&P 500 Index Price and 200-Day Moving Average

Sources: Bloomberg, SFG. Data as of 3/31/18. For illustration purposes only. S&P 500 Index price (in white) and 200-day moving average (in yellow). An investor cannot invest directly in an index. For additional information please see disclosures at the end of this commentary.

Not If, But When – The Volatility Bet

After 12 months of record low volatility, the VIX Index (commonly used as a gauge of expected stock market volatility) came surging back with a vengeance. On February 5th, volatility rose 115.60% in a single day alone and up 80.89% for the quarter. Even with the aggressive move, the VIX still did not surpass levels set by 2010, 2011, and 2015. From a historical context, following a period of extreme calm, the volatility spike shouldn't have been a surprise given its statistical predictability (see the following chart).

Volatility is Back (to Normal?)

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The speed of the volatility spike was somewhat of a phenomenon this time around given that the period of calm not only induced investors to chase equity returns, but to bet on volatility to continue to decline. These so called "short volatility" bets that worked in years prior quickly turned sour. With Bloomberg estimating anywhere from $1.5 to $2 trillion tied to the volatility market, the large unwind of these short volatility bets and other bullish derivatives added further weight to the market, potentially exacerbating selling. Popular exchange-traded vehicles with the objective of shorting volatility virtually blew up, losing over 95% of their value in less than a week. The damage was so extreme as to cause the closing down of the second largest inverse volatility exchange-traded note, XIV, in February.

Diversification Failing?

As equities sold off, bonds overall did not provide upside diversification. In fact, the Barclays U.S. Aggregate Bond Index lost more than the S&P 500 Index in the first quarter, returning -1.46%. While equities fought an onslaught of more pessimistic short-term views and technical downside pressure, the fixed-income market was caught in its own battle as yields continued to rise and traditional investment grade bond risk in rising rate environments continued to materialize.

U.S. 10-Year Treasury Yield Continued to Rise

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When asset prices are falling drastically, the only thing that rises is correlation. Investment grade bonds typically used for "flight to safety" have been suffering from constant pressure of yields moving higher. From the bottom of the U.S. 10-Year Treasury yield on July 8, 2016 through the end of the most recent quarter, the Barclays U.S. Aggregate Bond Index lost 1.35%, over the span of 629 days. The correlation between the S&P 500 Index and the Barclays U.S. Aggregate Bond Index made a U-turn, with 90-day correlation spiking from -0.80 to above 0.40.

U-turn: Correlation Stocks and Bonds

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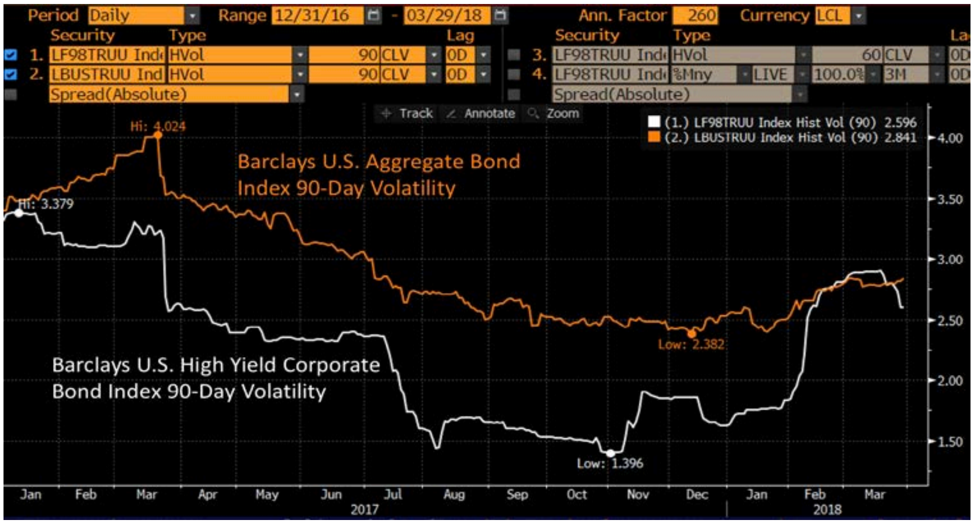
Portfolio Recap

Our portfolios not only seek to be diversified by asset class, but also by investment style. In Q1 2018, some of our strategies allocated into a defensive position, but most remained fully invested. Although the sharp increase in the U.S. 10-Year Treasury yield elevated volatility of investment grade bonds, the overall volatility of high-yield corporate bonds remained relatively low. On two of the more volatile days in the quarter that started the selloff in equities, the S&P 500 Index was down -2.12% and -4.10% (February 2nd and February 5th, respectively). On the same dates, the Barclays U.S. Corporate High Yield Index was down -0.30% and -0.22%. In fact, 90-day volatility of high-yield corporate bonds on average was actually lower than investment grade bonds. Overall, the high-yield corporate bond space did not seem to move into a "risk-off" mode yet.

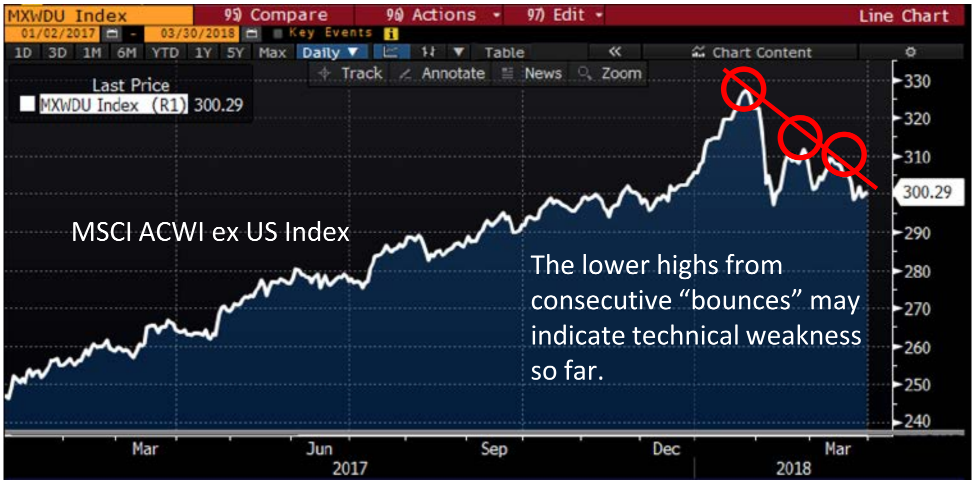
90-day Volatility: Lower in High-Yield than Investment Grade Bonds



Sources: Bloomberg, SFG. Data as of 3/31/18. For illustration purposes only. An investor cannot invest directly in an index. For additional information please see disclosures at the end of this commentary.

Unlike high-yield corporate bonds, high-yield municipal bonds are more sensitive to interest rate risk. With the sharp increase in yields, the risk of the U.S. 10-Year Treasury yield breaching 3% was mounting. We went "risk-off" in high-yield municipals in late January due to the persistent downtrend. In equities, our international equity portfolio went "risk-off" shortly after volatility spiked in February. The recovery has been weaker in international equities than domestic so far. The strategies seek to be reinvested once prices trend higher.

International Equities: Weaker Recovery



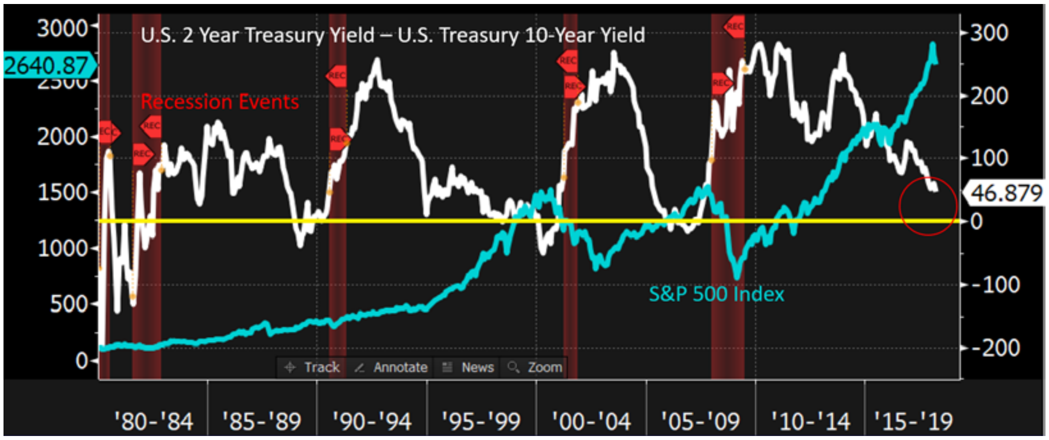
Sources: Bloomberg, SFG. Data as of 3/31/18. For illustration purposes only. An investor cannot invest directly in an index. For additional information please see disclosures at the end of this commentary.

It is important to remember that our tactical strategies are designed to be dynamic, seeking to participate in upside capture while minimizing relative downside risk. We continue to manage our portfolios with a rules-based methodology, seeking to set the stage for a higher probability of success, whether the markets recover and move higher, or continue their downward slide.

Conclusion

While no one can predict the future, the yield curve has historically been a good indicator of recessionary events. The yield curve, measured as the yield difference between the U.S. 2-Year Treasury and U.S. 10-Year Treasury, has been flattening (the following chart displays the white line heading down towards 0). Historically, when the curve dropped below 0 a recession event occurred afterward. It is interesting to note that recent economic numbers have still been strong, and U.S. GDP has continued to expand. Consistent with the chart, we could still have a few years to go before a recessionary event. However, it would not be prudent to assume that any upside does not come without risk, as experienced recently. Even a technical correction can drop more than 10%.

Yield Curve Flattening



Sources: Bloomberg, SFG. Data as of 3/31/18. For illustration purposes only. Shown in white is the yield curve between the U.S. 2-Year Treasury and U.S. 10-Year Treasury. An investor cannot invest directly in an index. For additional information please see disclosures at the end of this commentary.

Many investors may believe the terms “risk” and “volatility” are synonymous. The key difference is that while volatility can come and go, risk to the investor is always there. In our opinion, the risk of any investment should be evaluated by the greatest expected potential loss or drawdown. For example, equities may experience volatility periodically, down 10-20% during a correction, but the risk of the correction turning into a 20%+ drawdown or bear market exists. Thus, investors in equities need to prepare beforehand to accept this type of risk. To the same extent, an investor’s risk tolerance shouldn’t change as a reaction to volatility in the markets. From our perspective, today’s volatility versus tomorrow’s volatility is irrelevant from a risk tolerance objective.

S&P 500 Index Declines in Perspective – The Deeper the Stock Market Decline, the Longer the Recovery
Declines in the S&P 500 since December 31, 1945 (Post WWII)

Decline (%)	Number of Declines	Average Decline (%)	Average Length of Decline in Months	Average Time To Recover in Months
5 - 10	50	-7	1	3
10 - 20	19	-13	4	8
20 - 40	6	-26	11	24
40 +	3	-49	21	57

Sources: Bloomberg, SFG. Data as of 3/31/18. For illustration purposes only. An investor cannot invest directly in an index. For additional information please see disclosures at the end of this commentary.

History doesn’t always repeat itself, but it often rhymes. Looking at the above chart for context, markets historically tend to recover over time. The question is how much time and how severe a pullback can an investor handle without capitulating. A 5-10% drawdown on average only took 3 months to recover, providing some comfort to the most recent pullback. However, the data shows that the larger the decline, the longer it historically takes to recover. A drawdown in the S&P 500 Index of 20%+ led to a 2-year recovery time, on average. This is why we believe it is important to have an active, tactical, risk-managed component in a portfolio that seeks to reduce exposure, with the goal of avoiding larger drawdowns.

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Equity is a stock or any other security representing an ownership interest. **Volatility** is used to describe uncertainty or risk in terms of statistical measure of dispersion (variation in prices) – realized volatility is based on historical volatility while expected volatility is based on a market estimate of future volatility. A **Technical Correction** is a decrease in the market price of an asset or entire market after extensive price increases. A correction is typically a decline of 10% or more from the most recent high in a market or security. **Market Capitalization (Market Cap)** refers to the total dollar market value of a company's outstanding shares. It is calculated by multiplying a company's shares outstanding by the current market price of one share. **Federal Reserve (Fed)** is the central bank of the United States that raises or lowers interest rates. The **Fundamental Data** include the qualitative and quantitative information that contributes to the economic well-being and the subsequent financial valuation of a company, security or currency. **Support** or support level refers to the price level below which, historically, a stock has had difficulty falling. It is the level at which buyers tend to enter the stock. The **200-Day Moving Average** is a popular technical indicator which investors use to analyze price trends. It is simply a security's average closing price over the last 200 days. **Technicals** are statistics of securities gathered from trading activity, such as price movement and volume**. Bullish** means that the price of a security is believed to be increasing over time. A **Derivative** is a financial security with a value that is reliant upon or derived from an underlying asset or group of assets. The derivative itself is a contract between two or more parties based upon the asset or assets. Its price is determined by fluctuations in the underlying asset. **Diversification** is a risk management technique that mixes a wide variety of investments within a portfolio. **Fixed-Income (bonds or investment grade bonds) Security**, commonly referred to as a bond or money market security, is an investment that provides a return in the form of fixed periodic payments and the eventual return of principal at maturity. A bond price falls as its yield rises. **Yield** is the income return on an investment. This refers to the interest or dividends received from a security. Yield shown may represent different yield types and calculations and varies from index (or asset class) to index determined by availability of data. An **Investment Grade Bond** is a bond with a credit rating of BBB- or higher by Standard & Poor's or Baa3 or higher by Moody's. It is judged by the rating agency as likely enough to meet payment obligations that banks are allowed to invest in it. **U.S. 10-Year Treasury** is a debt obligation issued by the United States government that matures in 10 years, backed by its full faith and credit. A treasury bond is a marketable, fixed-interest U.S. Government debt security with a maturity of more than 10 years. **Taper-Tantrum** has been widely used to define how the markets reacted to the comments by Federal Reserve Chairman, Ben Bernanke that the fed might slow down, or taper, the rate of bond purchases, which is part of its quantitative easing (economic stimulus) program. **Correlation** is defined as a statistical measure of how two securities move in relation to each other. **Flight-to-Safety** is the action of investors moving their capital away from riskier investments to the safest possible investment vehicles. **High-Yield Corporate Bond** is a type of corporate bond that offers a higher rate of interest because of its higher risk of default. When companies with a greater estimated default risk issue bonds, they may be unable to obtain an investment-grade bond credit rating. **High-Yield Municipal Bond** is a lower rated security issued by less creditworthy municipalities. As such, they typically offer the highest yields of all municipal bond funds. The **Interest Rate Risk** is the risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve, or in any other interest rate relationship. **Downside Risk** is the financial risk associated with losses. That is, it is the risk of the actual return being below the expected return, or the uncertainty about the magnitude of that difference. **U.S. 2-Year Treasury Note** is a marketable U.S. Government debt security with a fixed interest rate and a maturity of 2 years. A **Yield Curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. **Drawdown** is a measure of peak to trough loss in a given period. **Bear Market** is a market condition in which the prices of securities are falling, and widespread pessimism causes the negative sentiment to be self-sustaining. **Tactical** is an asset allocation approach that is geared towards minimizing risk while taking advantage of opportunities, moving in and out of certain investments based on a risk/return evaluation. **S&P 500 Index** is a stock market index based on the market capitalization of 500 leading companies publicly traded in the U.S. Stock market, as determined by standard & poor's. **VIX Index** is the Chicago board options exchange (CBOE) volatility index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. **VelocityShares Daily Inverse VIX Short-Term Exchange-Traded Note (XIV)** is an exchange-traded note issued in the USA by Credit Suisse AG (Nassau Branch). The Note will provide investors with a cash payment at the scheduled maturity or early redemption based on the inverse performance of the underlying index, the S&P 500 VIX Short-Term Futures Index less the Investor Fee. **Barclays U.S. Aggregate Bond Index** is an index that consists of investment grade U.S. Government bonds, investment grade corporate bonds, mortgage pass-through securities, and asset-backed securities. It is often considered representative of the U.S. Investment-grade fixed rate bond market. **Barclays U.S. Corporate High Yield Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. **MSCI ACWI ex USA Index** is a market-capitalization-weighted index maintained by Morgan Stanley capital international (MSCI) and designed to provide a broad measure of stock performance throughout the world, with the exception of U.S.-based companies. The MSCI all country world index ex-U.S. Includes both developed and emerging markets.

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