Comments on Market Volatility

Stock price volatility experienced a sharp increase recently in light of economic reports that forced investors to reassess the valuations they were placing on equities. Stocks, like any investment, have a present value that is a function of the discounted future cash flows they are expected to generate.

For the last year or so, the outlook for future cash flows improved meaningfully due to an improving global economy and the benefits of lower corporate tax rates. At the same time, interest rates, a key component of the discount rate used to value those future cash flows, remained at low levels. The combination of improving fundamentals and low interest rates led investors to place a high valuation on stocks.

The current spike in equity market volatility coincided with the release of January U.S. employment statistics. Included in the report was data showing the strongest annual wage growth since 2009. This led to concerns that inflation would accelerate, which in turn contributed to a sharp rise in U.S. Treasury yields.

The rise in yields following the January employment report forced investors to reassess the discount rate they were using to value stocks. At the same time, the higher bond yields made their valuations more attractive relative to equities than they had been.

In our opinion, the recent bout of stock price volatility is a function of financial markets' attempting to recalibrate stock valuations. The level of volatility may be heightened because investors have been lulled into a false sense of security following an extended period of calm in the markets.

We don't believe that the elevated level of stock price volatility reflects investor unease about company fundamentals. To the contrary, the current quarterly reporting season confirmed the positive outlook for corporate earnings based upon an improving global economy and lower U.S. corporate tax rates.

As long as fundamentals remain strong, we believe volatility will eventually subside. In the meantime, we would expect to take advantage of price swings to add to stocks that are marked down to more attractive values and trim those that achieve our price objectives. We would recommend investors do the same with their investments.

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