DoubleLine

Four Reasons for Volatility in 2018

1. Central Bank Quantitative Tightening
2. Increased Fiscal Deficit
3. Rising Interest Rates
4. Historically High Valuations

The S&P 500 Index fell -8.8% from its peak on January 26th, and the 10 year U.S. Treasury note yield has risen .41% since the start of the year. The recent correction in equities appears to be accentuated by vulnerable market structures that have been built up by the prolonged period of extremely low volatility. At the start of the year, we believed we had seen the lows in market volatility and expected higher volatility going forward. Our expectation for higher volatility was due to headwinds from central bank quantitative tightening, increased fiscal deficit, rising interest rates and historically high valuations.

Our warning to investors was simple, expect higher volatility moving forward and position your portfolios defensively to take advantage of any potential market dislocations. Since the most recent sell off our views remain the same. We believe there is no recession risk over the near-term, but the US economy appears to be in the later innings of the economic cycle. Typically, at this stage of the economic cycle, inflation pressures tend to rise as commodities and wage prices increase. The rising inflation pressures tend to push the U.S. Federal Reserve's hand to tighten monetary policy which eventually terminates the economic expansion - a key medium-term risk in our view.

Moving forward, we believe volatility will remain higher than last year. The increase in volatility across risk assets reminds us to be patient and avoid knee-jerk reactions. This is the type market environment where no changes to asset or sector allocation can be an acceptable investment decision. While we do not forecast a recession in the immediate future, further central bank quantitative tightening, increased fiscal deficit and rising bond yields are all events that could lead to volatility - especially at historically high valuations.

We prefer to make asset allocation decisions based on longer term outlooks, like rising commodities, higher yields, and a weaker U.S. Dollar. Additionally, we continue to feel a sense of complacency amongst investors and their allocations towards higher risk assets. We caution investors to favor defensive portfolios and not chasing return.

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