GLOBAL FINANCIAL
Private Capital
COMPREHENSIVE WEALTH MANAGEMENT

The Real Danger In This Market

SYNOPSIS

- Volatility has surged across global bond markets due to improving economic conditions and fear that the Fed will raise interest rates sooner than later.
- The real danger that exists right now in markets is not the volatility, but rather how this volatility will cause investors to react.
- Staying the course is the best advice during times of heightened volatility predicated upon an emotionally-driven response to short-term disruptions.

IT'S BACK

While I have written extensively over the past six months about why investors should expect to see volatility rise instead of fall, the recent surge which has caused global yields to soar caught nearly everyone off guard.

For example, the German 10-year government bond (commonly referred to as the "Bund") yielded around 0.05% in April, and today it's climbed to just about 1%. A move of this magnitude in one of the safest assets in the world is nothing less than jaw dropping.

However, it's important to take a step back and ask where we were prior to the selloff. Back in April before the volatility arrived, there were trillions of dollars of government bonds in Europe offering negative interest rates. Yes, investors were *paying* governments for the privilege of loaning them money.

Environments that display such irrationality as an investor paying someone to loan them money are primed for violent moves in the opposite direction. They become compressed springs over time that ultimately snap due to catalysts that are unpredictable and remain a mystery well after (perhaps investors simply woke up to the notion that they were locking in guaranteed losses).

The volatility that caused the selloff in Europe has been amplified by concerns at home over when the Fed will ultimately raise interest rates for the first time since 2006. Recent economic data point to the potential for material wage gains for Americans, and this is almost always the catalyst for inflation.

NOTE*: The Fed needs to see continued evidence that inflation is rising because they can then conclude that our economy is growing and no longer needs ultra-low interest rates.*

Traders are buying and selling government bonds on these data releases, attempting to profit from the timing of an interest rate move. Such a strategy is highly emotionally-driven and very short-term focused.

> ***"The real danger that exists right now in markets is not the volatility but rather how this volatility will cause investors to react."***

Need evidence to support my claim? Watch the price action of any assets being held for income react when newly released economic data shows that the U.S. economy is improving. If the data is good then most likely the price of these assets will be under pressure.

Take a look at what's happened to dividend paying stocks lately. These assets represent some of the best long-term performing investments, yet they have been hit lately because traders believe that rising interest rates will hurt these stocks.

Why? Their logic is simple but also highly flawed. Traders believe that investors who own dividend paying stocks will sell once rates move higher and go into safer assets that are now paying higher yields such as high grade corporate bonds or even U.S. Treasury bonds.

The flaw in this logic is that the Fed will not be raising interest rates all that much in aggregate over the next two years. Hence, the yields on select dividend paying stocks will likely remain higher than most "safer" assets, and these stocks will also participate from an improving economy because their dividends become safer and could even grow.

Simply put, the volatility we are witnessing is nothing more than an emotional response to short-term concerns that are irrelevant to long-term investors (particularly those focused on income).

IMPLICATIONS FOR INVESTORS

The real danger that exists right now in markets is not the volatility but rather how this volatility will cause investors to react. Volatility-inspired panic selling has almost never helped anyone, and it most likely will not now.

Whether we like it or not, markets will continue to move on anticipation of when the Fed will act. This may be an unfortunate reality for some, particularly those who are short-term focused, but for investors who can keep their eye on the long run, volatility fueled by such absurdity as an insignificant rate hike creates opportunity.

The question then becomes how do we capitalize on such opportunity? Ironically, often times the best way to play a market move/shift is to stay the course, and this is precisely my plan to navigate through this recent surge in volatility for three key reasons:

1. **Lower for Longer:** Even if the Fed raises rates tomorrow, we will not be returning to the days of easy income anytime soon. Therefore, the yields offered on dividend paying stocks and higher yielding bonds will remain attractive to those who hold these assets for the income for years to come.
2. **Volatility is My Friend:** Volatility measures emotions in markets and NOT the fundamentals. Investors should welcome any opportunity to go discount shopping, particularly when high quality assets get dragged down over fears that are misplaced.
3. **Rising Rates are Good:** I've said this before and I will say it again. Rising interest rates from these levels is nothing more than an indication that our economy is growing and will likely continue to grow at this slow and steady pace.

Think about it this way. Let's say you own a portfolio yielding 5% at the moment, and this fear of an interest rate hike has caused your portfolio to experience some volatility and paper losses over the past few months.

Given the Fed will most likely not raise rates higher than 1% over the next 18+ months, do you really want to sell this portfolio and shift to an asset that may be yielding 2.5% in the face of an improving economy? Are you really willing to sacrifice the income just so your portfolio is less exposed to the emotions of traders?

The bottom line is that this volatility is nothing more than a gift to a long-term investor, and I am actively watching both equity and fixed income markets for any assets that go on sale because we are going to be stuck in a low growth and low income environment for far longer than just a few more months.

Sincerely,

Mike Sorrentino, CFA
Chief Strategist,
Aviance Capital Management
mikeonmarkets.com