Martone Capital Management: Weekly Investment Commentary (2/12/2018)

The initial market pressure that began two Fridays ago intensified last week, driving stock prices sharply lower amid intensely rising volatility. What started as concerns about overvaluation, emerging inflation threats and rising bond yields spiraled into a near-panic selloff as technical and structural market conditions exacerbated the slide. While we think the worst of the correction may be behind us, messy market conditions may continue. And the long-term outlook is growing more complicated.

For much of the past year, we have been cautioning that market volatility was too low and a consolidation or correction could come at any time. It appears it finally happened with a bang, driven primarily by inflationary pressures and a spike in bond yields.

While some of the associated technical market factors may prove to be transitory, investors and financial markets may have to adjust to a new reality of higher interest rates and rising inflation. These developments are likely to cause additional near-term volatility in the weeks ahead, and we would not be surprised to see more sharp back-and-forth movements in stock prices.

The good news, however, is that we see no real signs that the economy is headed for recession or that earnings are poised to retract. Without that happening, it is hard to see how a lasting bear phase for stocks could emerge.

Importantly, however, we also do not believe we will return to the low-volatility, relentlessly rising market environment that investors enjoyed in 2017. The era of moderate economic growth, rising profit margins, low or falling inflation and hyper-accommodative monetary policy is now over. In its place, we are seeing stronger and more durable economic growth, rising bond yields, higher inflation and slowly tightening monetary policy.

This isn't a bad environment for stocks, but it is more complicated. This backdrop is likely to put more pressure on equity valuations and contribute to higher levels of volatility (as we saw last week). As a result, we think investors should expect lower long-term returns and higher volatility. This is typical of later stages of an economic expansion and equity bull markets. And while it doesn't mean gains are finished, it does mean investors may have to become more selective.