DELTA INVESTMENT MANAGEMENT

Delta Insights
a weekly commentary on investing

Delta Investment Management is a registered investment advisory firm headquartered in San Francisco.
Delta welcomes discussions with individuals seeking investment advice and advisors seeking a new partner.
Delta manages portfolios at TD Ameritrade and Schwab.
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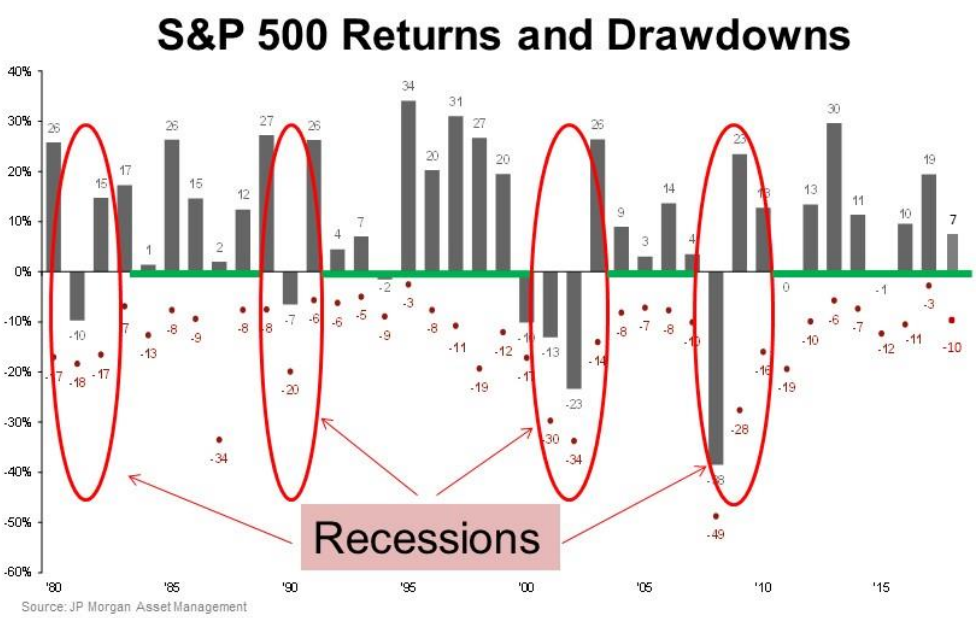
February 9, 2018

Volatility is a Two-Way Street

In finance, volatility is a bad word. It is measured as standard deviation and is how risk is defined. Investors hardly ever complain about upside volatility. At the high in January, the S&P 500 was up 7% for the year. Stocks were short-term overbought. Short-term overbought markets correct by price or time.

In February, volatility reversed course and the S&P 500 depreciated by nearly 10% from high to low. A 10% decline is often labeled a "correction."

The chart below shows calendar year S&P 500 returns without dividends (grey vertical bars). Below the bars are red numbers which indicate the maximum intra-year drawdowns. The chart makes clear that 10% drawdowns are fairly common. What is not common is a drawdown of only 3% which was the case in 2017.



Another important observation from the above chart is that as long as the economy is not in a recession (areas shown with horizontal green bars), the calendar year returns are usually positive. The U.S. is not currently in a recession.

Some of the recent volatility has been driven by institutions caught out of position. In January, we wrote about institutional short covering placing upward pressure on stocks. In February, some of the downward volatility was caused by institutions having to protect against rising volatility. In a heavily computer traded stock market, volatility can beget volatility. Short-term market volatility may take time to wash out.

The fundamental question is what changed since December 31, 2017?

1) Fourth quarter 2017 earnings reports were the best since 2012. S&P 500 operating earnings advanced by 22%. 76% of the companies exceeded their EPS projections and 67% beat revenue estimates.
2) 2018 forecast earnings have been revised up to 20%. Three months ago, consensus earnings growth for 2018 was 11%.
3) Because of rising earnings and stock price declines, the forward 12-month P/E of the market declined from about 18.4x to 16.6x. The 25-year average P/E is 16.1x.
4) The 10-year U.S. treasury yield climbed from 2.4% to about 2.8%. 60% of this advance was because of higher economic growth expectations rather than rising inflation. This is measured by comparing the change in the 10-year nominal treasury bond yield to the 10-year inflation protected treasury yield.
5) History shows that when rates rise from low levels (below 5%) on rising growth expectations, the stock market generally has positive performance over time.

At the end of 2017 we were bullish (see *Delta's 2017 Stock Market Outlook* dated November 17, 2017). Today, given the improvement in growth and price, we still are bullish.

Technically, the CBOE volatility index (VIX) gave a "buy" signal this week. It reached 50. Below is a chart of the VIX since 2000 with a white line showing the 50 level.

CBOE Volatility Index (VIX) Spikes

The VIX measures near-month put option buying on the S&P 500. Investors buy puts when they want to protect their long stock positions from a market sell-off. Historically, a 50 VIX has been associated with panic stock selling. We are likely to see the VIX remain relatively elevated (especially compared to the level of 10 where it was for the past year) in the near-term as imbalances are corrected, but the stock market should recover over time as volatility normalizes and panic subsides.

From January 1950 through December 2017, the S&P 500 has declined by 5-10% 41 times. The average length of the decline was one month. The average recovery from the low was one month. In the 11 cases that the S&P 500 declined by 10-20%, the sell-off lasted and average of 4 months and recovery took and average of 3 months.

Volatility can cause investors to make emotional decisions. Volatility can trigger institutional trading systems to accentuate trends with short-term momentum trades. Fundamentally, the stock market looks attractive at these levels. Technically, the market may not have found its lows. The good news is that share ownership of corporate stock has intrinsic value and over time the market will assign it fair value.

Give Us a Call Today

We invite you to give us a call at **(415) 249-6337**, visit www.deltaim.com or email us at info@deltaim.com if you have questions about how we can assist you in managing your investment accounts.

"And a little something for the wife."

Delta Stock Market Dashboard

MARKET SENTIMENT IS

BULLISH

THIS WEEK'S NUMBER IS

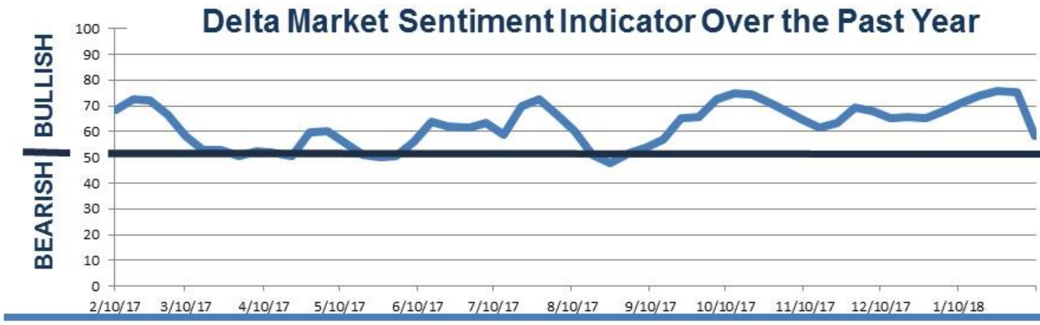
58.3

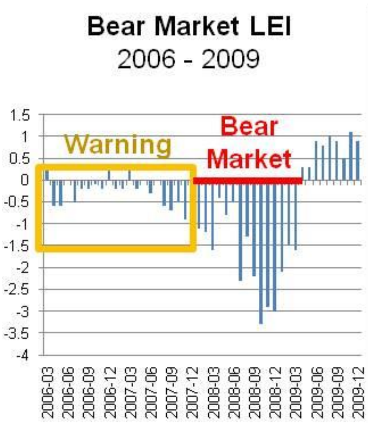
Our technical indicator decreased this week from 75.5 to 58.3

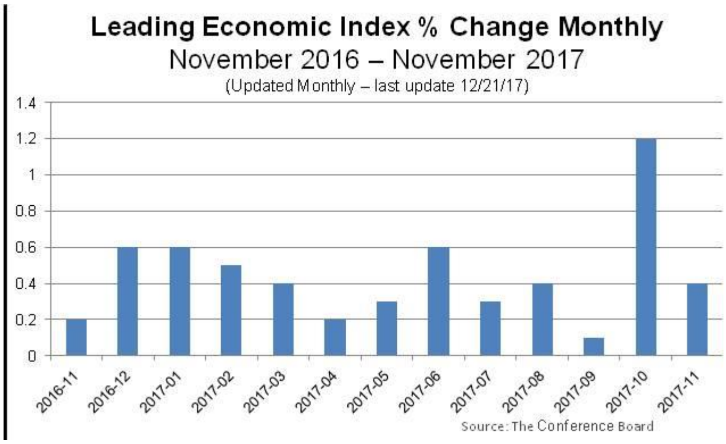
INDICATOR STATISTICS

Consecutive Bullish Weeks:	65
Cycle Inception Date:	11/15/2016
Range:	47.9 – 75.7
Mean:	63.6
Bullish Weeks YTD:	6
Bearish Weeks YTD:	0
*S&P 500	19.2%
*DJIA	27.1%
*NASDAQ	28.5%

** Percentage change during current cycle*







(Delta MSI is published every week in ***Barron's***)