Is Volatility Returning?

The current year has been one of unusual calm in the investment markets. Now that we're almost halfway through December, it has been a period of minimal market fluctuation along with well above average upward progress. The latter is largely a reflection of continuing momentum reflecting underlying advances in profits, both domestic and international. Yet, the stability stands in distinct contrast to the traditional pattern seen in almost every preceding year.

Corrections, pullbacks, and interim dips in stock prices are normal events. Although two out of three years show gains from start to finish, these gains are rarely linear. Indeed, along the way it's most likely that there will be a drop of about 10%, on average. In the absence of some unforeseen (aren't they always?) event between now and New Year's, 2017 may well go down as the calmest year ever.

Still, there's already evidence that the situation may be changing. Just recently, in short order, the news from Special Counsel Robert Mueller's investigation indicating that General Michael Flynn will be cooperating with that probe quickly sent the leading averages tumbling. Although much of that plunge has seen been retraced, this reaction suggests that the stability of the ongoing stock market gains is significantly less than many would hope.

There may be more news of this sort forthcoming. When these kinds of isolated developments turn into a pattern, might that derail the market's progress? Perhaps no such thing will take place, but given the continuing richness of stock valuations, it would be prudent to pay close attention to ongoing developments in the D.C. area.

From a purely economic perspective, one can easily become optimistic about what lies ahead by considering the health of the U.S. corporate community and the strength of the Consumer Confidence Index as well as the resilience of business abroad. Even so, there's a distinct difference between optimism and expectations that the best case scenario will actually turn into reality. Hope for the best case, but plan for the worst case typically proves to be a better approach.

As we approach the year-end holidays, many of us have reasons to be thankful for our investment successes. With that said, however, it would be naïve to think that what we have recently experienced represents a new normal. Looking back over many decades of stock market history, it's quite clear that big gains are invariably followed by lackluster or just plain poor performance.

The most recent example of this was the sparkling market of 1999-2000, followed by the flame-out of 2001-2002 and the essentially dead first decade of the new millennium. The good news is that the current-year progress has not taken valuations to the absurd levels of that quirky era, so it seems more likely that what's to come will be more of a moderation rather than a complete bust.

When the tide turns, investors should expect a noticeable increase in volatility. The occasional price flurries we have already noted may be a harbinger. Once a slide starts, it's likely to be precipitous. Whether it will be long lasting is another question.