Breaking News: Volatility Ahead

The combination of exceptional investment returns registered last year and rising heat in the geopolitical arena suggests that this year will see an increase in day-to-day price volatility. Although seasonal volatility tends to increase during late summer and early autumn, it seems likely that we'll be seeing wide fluctuations much sooner.

These days, when we see moves of a few hundred points in one direction or another, it's really no big deal. A big deal now would involve several *thousand* points. Don't rule that out.

In addition to the seasonal likelihood of volatility, there's the typical tendency of the market to rebound following a drop. Sometimes it quick. Other times, it's slow. But it always happens.

So here we are less than 11 months before one of the most critical elections in recent history and we have to wonder what the impact will be and how we can prepare for it. Will the markets continue to creep up or are we are about to go into the abyss.

On the equity side, there are always folks who talk about the market being too high, but that's an ongoing conversation. I remember several decades back when the Dow struggled to break through 1,000. Now it's above 28,000.

Yes, current valuations seem a bit full, but there's a big difference between a bit full and the Never-Never-Land valuations of 2000-1, which were nearly double those of today. Stock values depend primarily on underlying profits and interest rates.

So let's look at profits. The pace of corporate profit growth has been moderating for several quarters and there's little reason to expect a significant acceleration from this point. The saving grace, however, is that interest rates remain near historic lows, which means that the return on stocks is higher than the return on bonds and other fixed-income instruments. Therefore, stocks are still more desirable investments.

Even so, there has been considerable (perhaps excessive) interest in stocks with high dividend yields and, not surprisingly, this group may be approaching valuations that are not fully justified. But when stocks are jumpy, generous dividends can calm things down. A worthwhile focus here is companies that regularly increase dividends. Although often favored in this group, utilities may be vulnerable to price erosion since their price movements tend to move inversely with interest rates, which may be rising.

It seems increasingly likely that the rise ahead will be gradual and not far reaching. Higher returns are available, but that will mean accepting increased risk, which may make it worthwhile to consider short-term, high yield bonds and closed-end, term trusts with a definite maturity date.

The key is understanding that fluctuations are temporary. The long-term path of least resistance is up.

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