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# The Return of Volatility

This Goldilocks economy is in for a difficult correction. But that doesn't signal that a bear market is looming.

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**I**n late spring, volatility in financial markets reappeared, in some instances with a vengeance.

Riskier asset classes — particularly emerging-market equities and commodities — experienced double-digit price moves, often over short periods. The S&P 500, while more stable, declined more than 7.5% in less than six weeks from its May 5 cyclical high, recovering only modestly by the end of the quarter.

### **A Forerunner of Future Instability?**

The return of high volatility and the sell-off in risky assets could be viewed as a momentary spasm in ongoing bull markets. On the other hand, the recent financial market behavior may be a harbinger of more fundamental changes — the first steps in a risk repricing that could produce greater volatility and restrain potential returns from many assets going forward.

For more than three years, we have experienced an uncommonly supportive environment for prices in almost all asset classes. Among the reasons:

- To combat the economic slowdown at the beginning of this century, central banks injected significant amounts of money and credit into their economies, which spurred growth and encouraged financial risktaking.
- Global economic growth has been higher than projected, which has helped stimulate the economy.
- Inflation has remained contained.

This benign environment — often labeled a Goldilocks economy in the United States — is now at risk of changing. Among the growing list of challenges:

- Record current account imbalances,
- Increases in oil and commodity prices, and
- The risks posed by high — and, in many places, inflated — housing prices.

## As Goes U.S. Spending, So Goes the World Economy

Spending in the United States, one of the key drivers of world gross domestic product (GDP), is now slowing. The American consumer faces rising energy costs, a cooling property market and higher interest rates.

The world economy may be resilient in the face of this slowdown, thanks to cyclical recoveries that appear underway in other countries, particularly in Japan and Germany. However, the growing links between U.S. consumption and Chinese production, the other key driver in world GDP, suggest otherwise.

## Inflationary Pressures on the Rise

As uncertainty about the outlook for growth increases, inflationary pressures also are rising.

Exceptional global growth has been depleting “slack” in the world’s economic system. Authorities in the United States and Japan judge their economies to be running near full capacity.

The dollar’s continued depreciation, which we believe likely, will exacerbate this pressure in the United States. A weaker dollar should stimulate incremental demand for U.S. products in foreign markets.

Meanwhile, other sources of inflationary pressures have been building. For example:

- Housing prices have increased strongly in most countries during this economic cycle and continue to grow rapidly in many markets.
- The prices of energy and other commodities have reached record levels. This has created uncertainty as to whether the world is reaching a “tipping point” in its capacity to supply ever-greater quantities.
- Wages are now rising in most economies, including China and other emerging markets.

## Worldwide Money Constrictions

Central banks around the globe have been tightening monetary policies in response to this combination of strong economic growth and increasing inflationary pressures. At last count, more than 20 central banks had enacted more than 60 separate interest rate hikes so far in 2006. We are now in the first synchronized

global monetary tightening cycle in more than five years.

The Federal Reserve is a key player in this unfolding global scenario and is emblematic of the issues most central banks are now confronting. The Fed began its tightening cycle early. That tightening now appears to be producing slower economic growth.

Inflation, however, remains troublesome, which raises the probability of more rate increases before the tightening cycle ends.

## Correction Coming, But Bear Unlikely

Increased uncertainty about the future course of economic growth, inflation and monetary policy will probably produce the first meaningful correction in U.S. equities in more than three years. However, this correction and the accompanying repricing of risk in other asset markets is probably not the beginning of a new bear market. Why?

- Business is entering this period in the best operating and financial condition in decades.
- Profit margins stand at their highest level in post-war history.
- Corporate earnings have now reached a record share of national income.

This profitability, and its accompanying generation of cash flow, provides a solid foundation for capital markets. Dividend payments, share repurchases, and mergers and acquisitions are all at historic highs. This will provide additional underlying support for capital markets.

## The Bottom Line for Your Portfolio

Increased volatility and sell-offs in many risky asset classes signal the possibility of more difficult financial markets over the short-term. In anticipation, we recommend reducing risk and increasing cash allocations.

From a strategic perspective, however, we would maintain equity allocations near longer-term norms. Expanding risk premiums typically create attractive return opportunities, and markets sooner or later adjust to less liquidity. The strong profit cycle and compelling valuations suggest such a scenario is likely to play out over the next six months. ■

The recent behavior of financial markets may be a harbinger of more fundamental changes underway.