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WEEKLY INVESTMENT COMMENTARY

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A Call for Quality as Volatility Turns Up the Volume

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Stocks Struggle Again

Stocks mounted more losses last week amid sharp intraday gyrations. The tech-heavy Nasdaq Composite Index fared the worst, falling 2.92% to end the week at 4,686, while the S&P 500 Index dropped 1.38% to 1,931 and the Dow Jones Industrial Average declined 0.43% to 16,314. Meanwhile, the yield on the 10-year Treasury rose from 2.13% to 2.16%, as its price correspondingly fell.

What was different last week, unlike most of the past few months, was that markets were contending primarily with issues specific to individual stocks and sectors. Overall, investors should expect the current high-volatility environment to persist — regardless of the cause.

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Sector-Specific Issues

The economic data came in mixed last week. There was a weak Chicago Fed National Activity Index report and soft existing home sales, but second-quarter gross domestic product revisions were positive. While this played a role in the market's struggles, the real catalysts were at the industry level.

Biotech stocks traded down close to their August lows, near bear market territory, following a tweet from Hillary Clinton that raised the specter of price controls in the biotech sector. Stocks in Europe, particularly automakers, were punished on the back of the Volkswagen emissions cheating scandal. Finally, industrial bellwether Caterpillar lowered its revenue forecast and announced 10,000 job cuts, putting U.S. industrial companies under pressure.

Bonds also lost ground last week. Prior to a speech by Federal Reserve (Fed) Chairman Janet Yellen on Thursday, 10-year Treasury yields traded down to a one-month low of 2.12%, with bond yields also falling in Germany, Italy and Japan. The dip in yields was primarily driven by another drop in inflation expectations, with 10-year breakeven rates falling back below 1.50%. Except for a brief dip in late August, this is the lowest level for U.S. inflation expectations in more than five years. This is somewhat surprising given the relative resiliency of the U.S. economy, but part of the explanation for the drop may be that investors are being overly influenced by the decline in crude oil prices. Yields did bounce back on Friday following Chair Yellen's speech, in which she suggested the *Fed may still raise rates* prior to year's end.

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Managing Volatility

Last week's losses evidenced how the investment climate has changed. Investors are still coming to grips with *how to manage* something we have not seen in a while: a regime of above-average volatility. For example, last week an exchange-traded note that allows investors to "buy" volatility experienced its strongest flows since the spring of 2013.

One risk investors may be watching this week is centered in Washington. Congress needs to pass a continuing resolution by Sept. 30 to keep the government funded and avoid yet another government shutdown. While a near-term shutdown is not our base case, U.S. political uncertainty rose on Friday following House Speaker John Boehner's announcement that he will resign from Congress at the end of October.

We believe the combination of slower global growth, uncertainty as to the Fed's future path and less benign credit market conditions suggests that this period of heightened volatility is likely to persist. Rather than attempting to time each swing, investors may be better off managing the risks embedded in their portfolios.

While value stocks are at risk should economic growth estimates continue to come down, momentum companies are exposed to more spikes in volatility, a factor that has contributed to biotech's recent underperformance. Conversely, so-called quality stocks, which generally have strong return on equity and low debt, are better supported should volatility remain elevated.

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