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Volatility and 2008

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The first week of the trading year is not even finished, and the S&P 500 is already on track to have its first 2% down day of the year.

In 2007, there were 15 trading days in which the S&P 500 moved up or down by at least 2%. In 2006, there were two 2% single-day moves - and both were up. We had zero 2% moves (either up or down) in 2004 and 2005.

I'm telling clients to expect another bumpy ride in 2008. There are a vast array of economic concerns, earnings are going to decelerate, and the Presidential election will cause more than its share of blips. Meanwhile, global capital is at all-time highs, and it is sloshing around the markets with lightning speed.

The net effect of high volatility on investor sentiment is negative. We are wired to experience myopic loss aversion, meaning we hate losses roughly 2.5x as much as we like the same amount of gains. Lots of volatility has the effect of wearing on the nerves for the normal person.

2007 was a case in point. Although the major averages ended the year modestly in the black, most investors ended the year exhausted by all the turbulence. I think 2008 will be just as tiring, if not more so, than 2007.

For those that have the stomach to stick around for the whole year, I believe equities will be modest to moderately rewarding, especially compared with bonds, cash, real estate, and most alternative investments. The forward earnings yield on S&P 500 is right around 7%. According to the various iterations of the Fed Model, when earnings yields are above bond yields, stocks are undervalued. While not a perfect indicator (does a perfect predictor actually exist?), since the early 1980's the Fed Model has done a better job than P/E analysis in predicting 12-month stock market performance. It is bullish for equities that the Fed Model showing a 300+ bps. positive spread to 10-year Treasury yields. This won't necessarily lead to a blow-out year on the upside for stocks, but it should provide a nice backstop to prices.

The blow-out bullish scenario requires earnings to moderate less than expected AND stock multiples to expand. This isn't likely (I put the odds at 30% or thereabouts), but I think the odds are higher for a 20%+ up year than for a 20%+ down year in 2008.

The old overused bromide about "stock pickers' markets" will be key in 2008. I think Financials and Consumer Discretionary stocks will continue to be under pressure for much of the year. Health Care, Tech, Industrials, and Materials should provide a good number of profitable individual plays. I'm neutral on most of the other sectors.

As always, I think investors should be extremely cautious about linking their portfolio allocation decisions to top-down economic analysis. Nothing against economists, but if economic predictions were the key to generating excess returns, the Forbes 400 would be dominated by Phd.-toting economists and all the highest-rated mutual funds would be managed by economists. The fact that this is not the case should give us all pause.