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Stock Market Volatility: Schwab's Quick Take

By Schwab Center for Financial Research

U.S. and global stocks fell sharply Thursday amid fear of a potential Russian invasion of Ukraine and ongoing concern about inflation. The S&P 500 index closed down 2.1%, the Dow Jones Industrial Average fell by 1.8%, and the Nasdaq fell 2.9%.

U.S. producer prices rose faster than expected in January. The Producer Price Index jumped 9.7% year over year, exceeding the 9.1% consensus forecast. Coming on the heels of a bigger-than-expected rise in consumer prices in

January, the gain underscored concern that the Federal Reserve may significantly and swiftly raise short-term interest rates to control inflation.

Investors sought safety in safe-haven sectors and asset classes. The traditionally defensive Consumer Staples sector gained 0.9%, while the 10-year Treasury bond yield fell to 1.97% as bond prices (which move inversely to yields) jumped. The Nasdaq 100—which is heavily weighted toward economically sensitive Information Technology stocks—lost 3%.

U.S. stocks: Inflation is an ongoing concern

- Thursday's selloff emphasized how worried investors are about inflation. Higher prices are hurting consumer confidence. A tight labor market, rising wages, and higher energy prices are viewed as having the potential to speed up the Fed's timeline for tighter monetary policy.
- Speculative stocks, which have seen considerable losses over the past year, were hit hardest. Companies with weak fundamentals—such as no earnings and weak free cash flow yield—were bought strongly throughout the pandemic, but the subsequent tightening of financial conditions has hurt their performance.

Global stocks: Markets are watching the Russia-Ukraine situation

- Accusations of cease-fire violations in eastern Ukraine weighed on markets. However, it's worth noting that since the 2015 cease-fire ended major combat following Russia's annexation of Crimea in 2014, the Organization for Security and Cooperation in Europe (OSCE) has logged hundreds of cease-fire violations. They are not necessarily a prelude to invasion.

- Geopolitical events involving Russia since the fall of the USSR have had little impact for globally diversified investors. The human costs of military action are unmeasurable. However, on the day Russia invaded Georgia in 2008 and Ukraine in 2014, U.S., developed- and emerging-market stock indices around the world dipped less than 2%. They rebounded at least partially during the following five days.
- The potential for disruptions to energy flows could slow Europe’s economy. However, the rise in energy prices over the past year could already reflect some disruptions, and governments are capping prices for consumers to lessen the impact.
- International stocks declined less than U.S. stocks on Thursday. Markets continued to pursue a theme driven primarily by rising interest rates: punishing stocks with expensive valuations while favoring cheaper stocks with more immediate cash flows, which are more prevalent in international markets than in the U.S.

Bonds: Safe-haven buying may cap rise in longer-term yields

- The 10-year Treasury yield dropped roughly six basis points to 1.97% on Thursday. Because they’re backed by the full faith and credit of the U.S. government, Treasuries are often considered a safe harbor during periods of geopolitical uncertainty.
- Short-term bond yields may continue to rise as the Federal Reserve begins to raise rates. For now, geopolitical concerns are unlikely to prevent the Fed from hiking rates at its March meeting, because high inflation needs to be addressed. We don’t anticipate a 50-basis-point (or 0.50%) hike in March, but we do expect the Fed to hike the federal funds rate (the rate banks charge each other for overnight loans) four or five times this year.

- Expect more volatility in the riskier parts of the bond market. Risks were already on the rise due to tighter financial conditions and the likelihood of slower economic growth in 2022. Geopolitical concerns usually result in investors shifting from riskier investments to the perceived safety of investments such as U.S. Treasury securities, which means volatility may remain elevated for investments such as high-yield bonds, bank loans and preferred securities.
- Interest rates for consumer loans, such as auto loans and business loans, may rise as the Fed hikes rates. Loans tied to short-term interest rates—like auto loans or credit cards—tend to be more sensitive to changes in the federal funds rate than mortgage rates, which are generally tied to long-term Treasury yields.

Trading takeaways: Volatility is likely to continue

- The volatility that began in early January is not over yet. After narrowly escaping correction territory (that is, down 10%) in late January, the S&P 500 is currently down 8.3% year to date, and down 2.8% in February alone. At Thursday's close, the S&P 500 was 8.7% below its all-time high reached on January 3, 2022.
- Key technical support levels continue to be challenged. After testing the 200-day simple moving average (currently 4,457) every day this week, the S&P 500 closed well below this key support level on Thursday. The Nasdaq Composite has performed far worse—after entering correction territory on January 19th and narrowly escaping bear-market territory (down 20%) only a few days later, it has not been able to rise above the correction threshold. At the close Thursday, the Nasdaq was down12.3% year to date and down 14.6% from its November 19th all-time high.

- Volatility remains elevated. At its current level (28.11), the VIX is implying daily moves in the S&P 500 index of 64 points in either direction, although Thursday's top-to-bottom range actually exceeded 83 points.
- Equity traders should consider reducing average share size and dollar amounts per trade. While equities could experience another sharp bounce-back at any time, large downside moves are likely to continue to occur with equal frequency in the near term.

What should long-term investors do now?

Market volatility is unsettling, but historically not unusual. If you've built an appropriately diversified portfolio that matches your time horizon and risk tolerance, it's likely the recent market drop will be a mere blip in your long-term investing plan.

However, it can be hard to do nothing when markets are rough. Given what has been happening recently, consider a few of our investing principles:

- **Establish a financial plan.** It's easier to ride out volatility if you have a financial plan based on your goals and investing time horizon. By keeping your eye on the finish line, you'll be less likely to panic and sell when prices are down.
- **Don't try to time the markets**. It's nearly impossible. Time *in* the market is what matters. While staying the course and continuing to invest even when markets dip may be hard on your nerves, it can be healthier for your portfolio and can result in greater accumulated wealth over time.
- **Build a diversified portfolio based on your tolerance for risk.** It's important to know your comfort level with temporary losses. Sometimes a market drop serves as a wake-up call that you're not as comfortable with

losses as you thought you were, or that a portfolio you assumed was appropriately diversified in fact isn't. Schwab clients can log in and use the Schwab Portfolio Checkup tool to quickly assess whether their portfolio is still in balance with their target asset allocation. If you're not a client, or haven't yet established an investment plan, our investor profile questionnaire can help you determine your profile and match it to an appropriate target asset allocation.

- **Rebalance your portfolio regularly.** Market changes can skew your allocation from its original target. Over time, assets that have gained in value will account for more of your portfolio, while those that have declined will account for less. Rebalancing means selling positions that have become overweight in relation to the rest of your portfolio, and moving the proceeds to positions that have become underweight. It's a good idea to do this at regular intervals. Schwab clients can log in and use the Schwab Portfolio Checkup tool to identify areas of their portfolio that may have drifted away from their target asset allocation.
- **Build in protection against significant losses.** Modest temporary losses are one thing, but recovery from significant losses can take years. Traditionally defensive asset classes, such as cash investments and short-term bonds, tend to perform better when stocks are down. When used for diversification, they can help buffer a portfolio against the effects of up-and-down markets. You'll also want to consider defensive assets for shorter-term goals or accounts from which you expect to draw money within the next few years.

What you can do next

- **Read more** about Schwab's perspective on current markets.

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