

As the equity market declined in May, the response of the options market, where expectations of future volatility are priced, and the bond market, where expectations of future interest rates are priced, could not have been more different. As shown in the table below, the implied volatility response to the equity market's decline was relatively muted as the Chicago Board Options Exchange (Cboe®) Volatility Index (VIX®) average for the month was well below past months with similar losses. Meanwhile, the bond market rallied and began to price in a significant probability of a Federal Funds rate cut as early as July. Investors may want to consider potential negative effects to their portfolios if Federal Reserve (the Fed) rhetoric and monetary policy do not match expectations going forward.

Monthly Average VIX® Levels S&P 500® Index Monthly Drawdowns of 6% to 7% 1990 - 2019		
Date	S&P 500® Index Monthly Return <sup>1</sup>	VIX® Monthly Average
10/31/2018	-6.84%	19.35%
1/31/1990	-6.71%	23.35%
<b>5/31/2019</b>	<b>-6.35%</b>	<b>16.72%</b>
3/31/2001	-6.34%	28.50%
8/31/2001	-6.26%	21.86%
4/30/2002	-6.06%	19.90%
8/31/2015	-6.03%	19.43%
5/31/2012	-6.01%	21.00%
1/31/2008	-6.00%	25.82%

1: Return set includes months from 1990 – 2019 in which the S&P 500® Index declined between 6.0% and 7.0%. Source: Bloomberg, L.P.

Is the bond market like the mythical Cassandra whose warnings are being ignored by equity investors? Or is the bond market Chicken Little—seeing an earnings slowdown and the potentially negative impact of tariffs as precursors to a protracted slowdown of the broader economy? One possibility is that the seemingly conflicting signals are actually an accurate reflection of the broader cross-section of investors participating in both markets. The response of both options and bond markets is potentially consistent with the expectation that the Fed plays the role of capital market risk manager, using soothing rhetoric and accommodative monetary policy to stave off fears of full-blown earnings and economic growth retrenchment. But what if the Fed cannot do what the market expects? Will it be able to execute a rate cut while the unemployment rate is at record lows and inflation is at its target level?

If the Fed's rhetoric and policy do not match investor expectations going forward, the equity market may be susceptible to additional downside and higher volatility. Uncertainty has always presented risks for investors, but risks associated with monetary policy and trade policy are changing the landscape of uncertainty and investors may need to adapt. In particular, the downside risks of the equity market may have increased and the Fed's ability to respond to equity losses may be limited if equity market downside does not coincide with broader economic deterioration.

Gateway's investment philosophy holds that consistency is the key to long-term investment success and that generating cash flow, rather than seeking to forecast the rise and fall of the market, can be a lower risk means to participate in equity markets. By staying true to its philosophy and consistently managing strategies aligned with its historical approach, Gateway will continue to assist investors in managing risk while pursuing long-term returns in this increasingly uncertain environment.