If 2017 were a cinematic thriller, it would have featured sharks circling and ominous music playing in the background, but not a drop of blood in the water. Audience members with exposure to the stock market were not disappointed by the lack of thrills in 2017, as equity market volatility was at historic lows and the market advance was well above average. As we switch movie reels to 2018, with the bull market on the verge of extending to nine years and equity market valuations at the high-end of their historical range, the sharks are still circling, and the ominous soundtrack can still be heard. Will there be blood in the water in 2018, or will the suspense continue to build?

Political dynamics, both domestic and international, were an element of the ominous background music in 2017. Significant geopolitical tensions remain, including unrest in the Middle East, North Korea's nuclear ambitions, Brexit negotiations and China's growing influence. With the Trump Administration emboldened by a key legislative victory, and midterm elections on the calendar in 2018, the domestic political climate is likely to remain divisive.

If downside volatility returns to equity markets in 2018, the trigger may more likely be tied to earnings or the economy rather than politics. With equity market valuations high and the Fed committed to normalizing monetary policy, there may be less valuation support and less policy support to prevent the next pullback from developing into a correction or worse. High equity market valuations have not always been a signal of an imminent market downturn in the past, but history suggests the strong earnings growth of 2017 may need to be maintained to justify current valuations. The early- to mid-1990s is an example of a high valuation period when strong earnings growth helped keep significant downside events out of the market.[1] However, the early- to mid-1960s is a counter example of a high valuation period when above-average earnings growth was unable to prevent bear markets.[2] Moreover, if earnings growth fails to meet expectations and the market softens, the Fed could be somewhat constrained on its policy response unless it is willing to abandon its commitment to normalizing policy through raising rates and shrinking its balance sheet.

[1] From December 31st, 1991 through December 31st, 1994, S&P 500® Index earnings grew more than 20% annualized. The trailing 12-month P/E began the period at 15.35, climbed above 20 by mid-1991 and stayed above that threshold until the first quarter of 1994. The worst peak-to-trough decline in the S&P 500® Index over this period was a drawdown of 8.47% from February 2nd, 1994 to April 4th, 1994.

[2] From December 31st, 1960 to December 31st, 1966 the cumulative growth of S&P 500® Index earnings was 53.72% (7.43% annualized) and the period had two bear markets. From December 12th, 1961 to June 26th, 1962 the S&P 500® Index lost 27.97% and from February 9th, 1966 to October 7th, 1966 the S&P 500® Index lost 22.18%.

Potential storylines for 2018 could include one where volatility increases, but with a surprising plot twist: nothing bad happens with regard to politics, earnings or the economy. The connection between volatility and negative developments is so strong that many may find this potential storyline too implausible. However, a key driver of low volatility in 2017 was very low correlation across individual stocks. Correlation across the 50 largest stocks in the S&P 500® Index was well below its 10-year average for much of the year and even approached zero during the fourth quarter. Average correlation levels are statistically associated with VIX® readings in the high teens, so it is possible that volatility levels could revert toward long-term averages on a change in the correlation dynamic alone. In other words, a significant rise in volatility would not necessarily require a deterioration in corporate earnings or economic conditions. This scenario would potentially be advantageous for option writing strategies that maintain exposure to the equity market as the market's upward trend could continue while cash flow from collecting option premiums increases.

In 2017, Gateway Investment Advisers, LLC celebrated its 40th year of operations and its flagship strategy now has a 30-year track record. Gateway has witnessed decades of market storylines and sustained its approach through a series of market thrills, chills and plot twists. The firm's investment philosophy is informed by its long history and maintains that the U.S. equity market is the most reliable source of attractive long-term returns, despite its high volatility relative to other asset classes and tendency to periodically deliver significant losses over shorter periods of time. Gateway's investment philosophy also 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 continuing to manage strategies consistently with the firm's historical approach, Gateway will continue to assist investors in managing risk while pursuing long-term return in this positive, yet uncertain, environment.