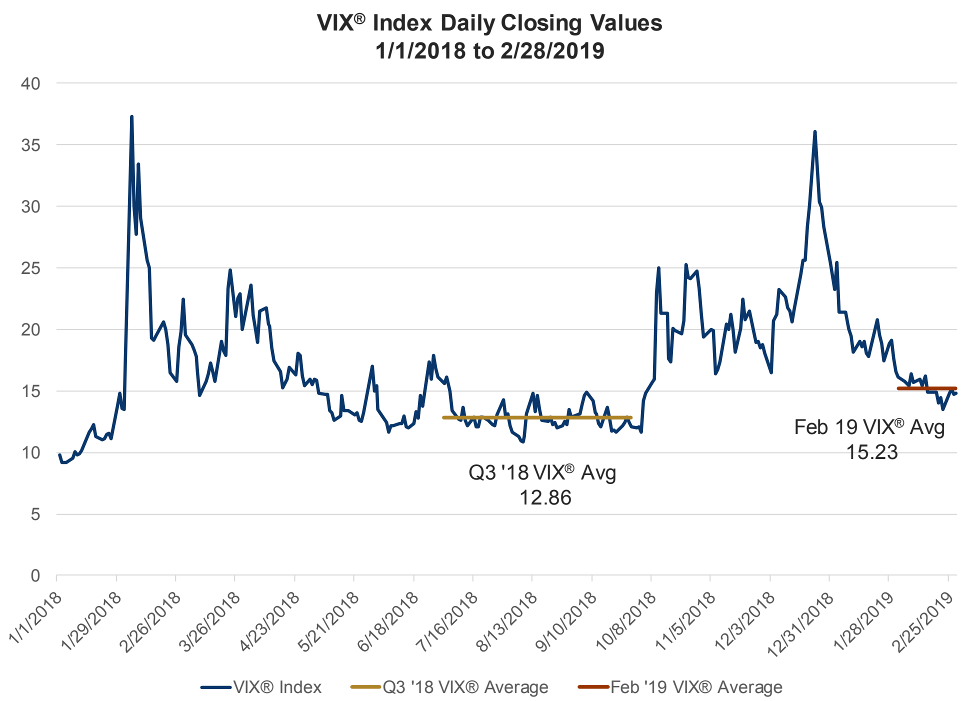
The equity market has come roaring back from its fourth quarter 2018 selloff, driven largely by key macro concerns including Federal Reserve rhetoric about the course of monetary policy normalization, trade tensions with China and the partial shutdown of the U.S. government. Resolution of, or at least progress on, these macro concerns helped propel the equity market higher through the end of February. In typical fashion, implied volatility has come down as equity markets have recovered. However, despite an easing of macro concerns and the sixth strongest equity market rally of the last 30 years, current VIX® levels remain meaningfully above levels witnessed during the third quarter of 2018, prior to the macro issues taking center stage.

Macro issues contributing to higher fourth quarter volatility may be helping to sustain current volatility levels as some issues are not fully resolved and others could quickly re-emerge or re-intensify. Macro issues do not tell the full story of the current volatility environment, however. The contribution of fundamental factors must not be overlooked.



One notable fundamental factor is the outlook for earnings growth. After a strong annual growth rate of nearly 25% in 2018, the current consensus for estimated 2019 S&P 500® Index operating earnings growth is less than 10%. Over the past several years, periods of decelerating earnings growth have experienced higher levels of implied volatility compared to periods of accelerating earnings growth.

Corporate capital expenditure is another fundamental factor that may contribute to the current volatility environment. Aggregate capital expenditures among S&P 500® Index companies increased more than 18% in 2018, the first year of meaningful increase after stagnating from the end of 2012 through 2017. Uncertainty as to how company-specific expenditures will impact profitability and competitive dynamics may contribute to volatility in the future.
There is a noteworthy difference between the uncertainty of outcomes that stem from capital expenditures and the easier-to-model impact of share buybacks, which have been a popular use of corporate cash flow in recent years. The impact to earnings per share from buybacks is simply proportional to the percentage change in shares outstanding. Additionally, buybacks will have little impact, if any, on the competitive dynamics of an industry. If the capital expenditure trend continues, it may lead to not only a more dynamic competitive landscape but also more volatility in earnings and other key fundamental metrics. Ultimately, this may result in greater price volatility, particularly if the share buyback trend wanes at the same time.