Investors received more tricks than treats in October. Some aspects of October's equity market volatility were as predictable and cliché as any cut-rate horror film. Namely, an October equity market selloff is not a very innovative plot twist. The month is notorious for market declines, and historically has been the most volatile month. Also, sharp short-term equity market pullbacks are common occurrences—the intra-year peak-to-trough decline of the S&P 500® Index has averaged nearly 13% over the last 30 years. October's loss was approximately half that and the pullback from a market peak on September 20th to the October closing low on October 29th provided a less-than-ghoulish return of -9.76%. Furthermore, the volatility response to the decline was not exactly hair-raising. The average closing value for the Cboe® Volatility Index (VIX®) was 19.35 for October, nearly identical to its long-term average.

Other aspects of October's market action were mysteries befitting a spine-tingling 'who-done-it.' First and foremost, most pundits were hard-pressed to come up with a convincing culprit on which they could blame the market's loss. Was it rising interest rates? Geopolitical tensions? The trade war? A precursor to surprise election results? Deterioration in the housing market? Disappointing earnings? All of the above? Moreover, as with all good mysteries, October gave investors a lengthy list of oddities to investigate: It was just the 17th time in the last 480 months (40 years) that the bond market delivered a loss when the S&P 500® declined 5% or more. The lack of a flight-to-quality response that typically benefits bond holders was truly shocking. Another surprise: realized volatility exceeded implied volatility—a phenomenon that has happened in just 12% of all months over the nearly 30-year existence of the VIX®. Finally, and perhaps most frightening, domestic stocks declined despite initial earnings reports that can only be categorized as strong: US aggregate growth is tracking at more than 26% year-over-year, 84% of companies reporting met or beat earnings expectations and over 40% of companies offering guidance revised expected future earnings upward while less than 20% revised future earnings expectations downward.

Perhaps the best explanation for October's market action is that investors are processing a transition phase for the economy and equity markets. Three important economic and market drivers are in transition: monetary policy, fiscal stimulus and corporate earnings. Not only is the Federal Reserve unwavering in its commitment to march short-term rates higher, but also the shrinking of its balance sheet as asset maturity has recently accelerated. The fiscal boost of the Trump Administration tax cut may be starting to wane. Finally, and potentially providing the most significant driver to ongoing volatility, the market may be pricing in a deceleration of earnings growth.

As we have noted in the past, the period of 1992 through 1994 stands out as one with very low equity market volatility despite market valuation levels that, at the time, were unprecedently high. Corporate earnings grew at an annualized rate of nearly 21% for the three-year period ending December 1994. Volatility began to tick up as the growth rate continued to increase and ultimately peaked in early 1995 before decelerating to a brief negative period in mid-1996. Though volatility picked up and the earnings growth rate downshifted, the equity market continued its upward trend during this transition.

Change can be scary, particularly when it materializes after a lengthy economic expansion or a bull market advance. Only time will tell the degree to which these transitions will play out and impact the economy and equity market. The end of the bull market in equities may not be nigh, but investors may need to persevere through higher volatility to reap longer-term gains. We hold our belief that long-term investors may benefit from seeking approaches beyond just blending traditional asset classes to achieve the optimal middle ground between stocks and bonds. Adding equity correlated investments that can mitigate equity market declines combined with greater long-term return potential than bonds may be beneficial. Strategies seeking to reduce risk and enhance risk-adjusted return through selling index options may be particularly attractive due to the higher premiums available in periods of elevated equity market volatility.