

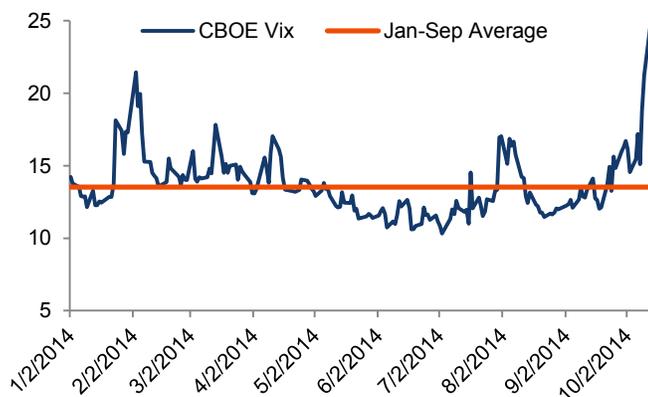
Volatility is Back, as Expected

- Volatility has picked up and markets have fallen of late, driven by investors' concerns about global growth.
- Looked at in isolation, recent events seem disconcerting; however, a longer-term view provides helpful context.
- If the current stock market correction has further to go, we would start to view it opportunistically.

After falling to extremely low levels from the start of 2014 through early July, market volatility has risen sharply. As a result, October has proven to be a challenging month for riskier assets. Many investors may find today's headlines disconcerting. The market just had its worst three-day run since late 2011. The S&P 500 has fallen below its 200-day moving average for the first time in almost two years. Relative to large-company stocks, small-cap stocks are having their worst calendar year since 1998 (measured by the returns of the Russell 2000 and Russell 1000, respectively). There are still serious concerns about growth prospects in China and Europe. Throw in a steady barrage of scary headlines, from armed conflict to terrorism and highly fatal infectious diseases, and panic might seems like an appropriate response.

We believe investors should breathe, relax, and take a step back. In periods of market and news-cycle turmoil, it's critically important to look at the big picture. For example, the short-term behavior of the Chicago Board Options Exchange's VIX Index (a measure of risk aversion derived from option prices on the S&P 500) has shot up in October (Exhibit 1).

Exhibit 1: Sharp Rise in Implied Volatility

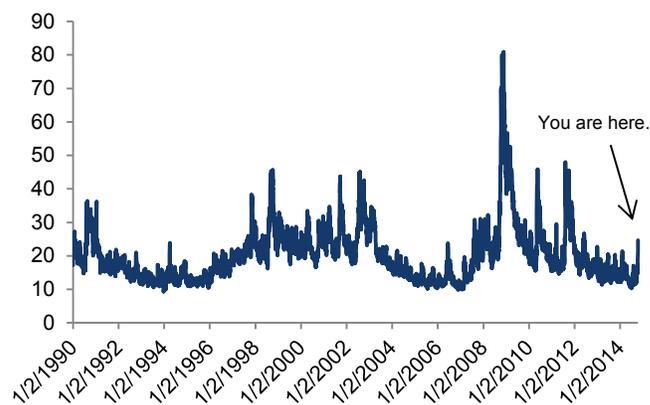


Sources: CBOE, Factset, SEI
Daily closing values through 10/13/2014; the VIX, calculated from options contracts on the S&P 500 Index, is an estimate of the expected 30-day volatility, in percentage terms, of the S&P 500.

First, this jump in volatility did not come as a complete surprise. As we noted in our second-quarter Economic Outlook, even during the summer lull, VIX futures were indicating the possibility of a “substantial rise in equity volatility over the next few months.” (VIX futures are contracts of varying length that are settled at a specified date in the future based on the initial and final values of the VIX Index.)

Second, stepping back to look at the longer-term behavior of the VIX puts its recent rise in perspective. While disconcerting to investors who have become accustomed to falling volatility in recent years, Exhibit 2 shows that the VIX is still at normal levels.

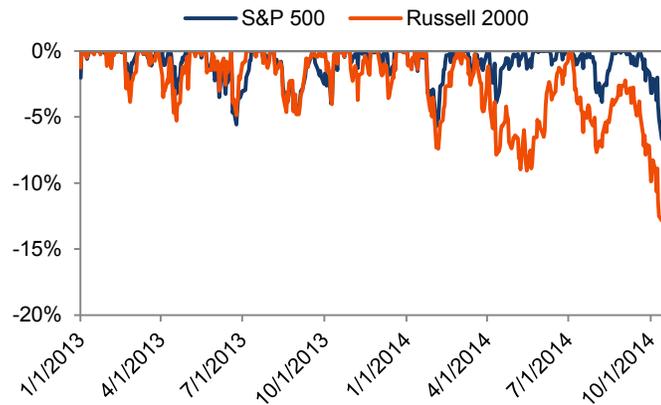
Exhibit 2: The VIX in Historical Context



Sources: CBOE, Factset, SEI
Daily closing values, 1/2/1990 through 10/13/2014

That's not to say that the recent jump in risk aversion hasn't done some damage. For example, the current drawdowns in U.S. equity markets are at their deepest since 2013, as shown in Exhibit 3 on the following page.

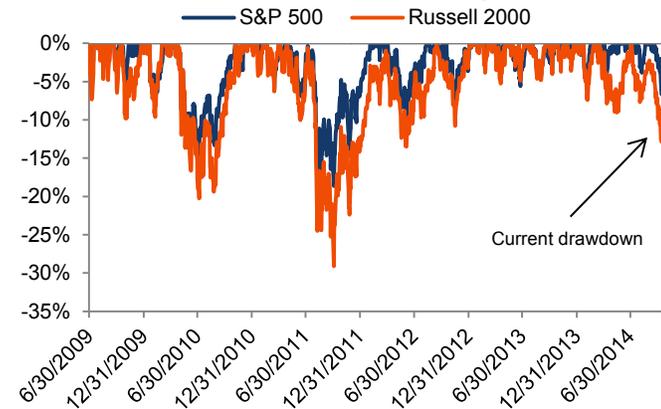
Exhibit 3: Sharp Stock Market Drawdowns



Sources: Factset, Russell, Standard & Poor's, SEI
Cumulative change from prior peak using daily returns

However, looking at the entire post-recession period, it becomes clear that the current correction in U.S. equity markets is still well short of those seen in 2010 and 2011, as seen in Exhibit 4.

Exhibit 4: Current Drawdowns in Perspective



Sources: Factset, Russell, Standard & Poor's, SEI
Cumulative change from prior peak using daily returns

Our View

When trying to discern the implications of the recent selloff, it's helpful to take account of the economic backdrop. As noted in our third-quarter Economic Outlook, "the global economic recovery is a work in progress." Concerns about economic growth in China and Europe (as well as Japan, Brazil and India) persist, but with the exception of recent signs of softness in Germany, these risks have been apparent for some time. Encouragingly, there seems to be growing recognition of the policy measures that may be required to pull China and Europe out of their current difficulties; however, we expect that progress could remain choppy. In the U.S., the Federal Reserve is expected to end its asset-purchase programs and eventually begin hiking rates. This is likely to act as a headwind too (both domestically and globally), but markets have had over a year to digest the prospect of tighter U.S. monetary policy. The U.S. labor market continues to improve at its slow but steady pace, and we expect corporate earnings growth to continue, though perhaps at a slower pace than in recent years.

Stepping back and looking at the overall investing environment, higher volatility should probably be expected, given the various headwinds and uncertainties facing the global economy. In fact, today's volatility levels are less puzzling, in our view, than the extremely low levels seen from February to July of this year. We may see the current correction continue deepen, but each correction since 2008 has proven to be a buying opportunity. As things stand today, we believe this will be the case for the current episode as well.

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