# THE END OF GOLDILOCKS?

The sudden spike in volatility and reversal of this year's exceptional stock market gains ultimately reflects concern over possible rising inflation commensurate with quickening economic growth. Pundits have cited technical reasons for the recent swoon: too many investors piled into an obscure financial instrument (inverse volatility ETF - symbol XIV) that produced gains as long as volatility remained low, but generated huge losses when volatility spiked. But the real reason is that the delicate balance of low interest rates and modest economic growth - sometimes referred to as 'Goldilocks' (not too cold, not too hot) - may be coming to an end.

It seems fairly clear that U.S. and global economic growth have improved and are accelerating. The Atlanta Fed's real time measure of first quarter U.S. economic growth is currently predicting 4% growth in GDP, unprecedented for this cycle. Good economic news is good. Great economic news could be 'bad', as the labor market is tight, and recent tax cuts and proposed increases in deficit spending are stimulative. The Fed is raising rates, attempting to get back to something resembling normal, but if it is forced to get more aggressive to combat inflation in an overheating economy, financial assets will likely be impacted.

It's often said and probably true that the bond market is a more sober barometer of economic health than the stock market. (We equity folk take no offense.) For this reason, investors and traders alike follow it closely. The U.S. 10-Year Treasury Note yield has been rising lately in response to stronger data, and it looks like it's making a run at the psychologically important 3% level. That's important because the economy hasn't been strong enough to hold that level for many years. As it ticked over 2.80% a week ago Friday, the equity market began to bleed. Fundamentally speaking, 3% shouldn't be a deal-breaker, but 3.5% or 4% might be. Traders decided they didn't want to wait around, spiking volatility, and imploding the XIV. Last Monday's serious tremor was the result, with aftershocks still being felt through the rest of the week.

We recently wrote that while financial conditions appear set to produce muted longer term returns, we didn't see excesses that warranted portfolio changes. We still feel that way. The economy can run a little hotter without overheating. It's good for profits and wages. But if that spells the end of Goldilocks, expect greater (i.e., more normal) volatility.

The Arrington Building
1802 Bayberry Court
Suite 400
Richmond, Virginia 23226

804.288.0404
800.787.7414
FAX 804.288.7872
www.lowebrockenbrough.com