



The Week

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Volatility diminishes

At the beginning of every year, it is natural to think about potential returns in the year ahead. However, given the volatility of the markets during the past few years, many investors are probably wondering about volatility too. The good news is stock market volatility appears to have declined since the financial crisis two years ago and could decrease even further if the economy continues to expand at a moderate rate in 2011 as we expect.

During the past few months, many investors have turned a bit more positive on stocks and more cautious on bonds. This is a significant change from the past few years when risk-averse investors favored bonds over stocks. In fact, recent data show that investors are now putting more funds into stocks and less into bonds.

We believe three factors are probably enticing investors to wade back into the stock market in recent months. First, the U.S. economy is slowly recovering from the deep recession of 2008 and early 2009. Second, during 2010, the stock market, as measured by the S&P 500, performed better than the intermediate-term government bond market. Third, stock market volatility appears to be declining as investors' concerns about a repeat of the 2008 bear market decrease.

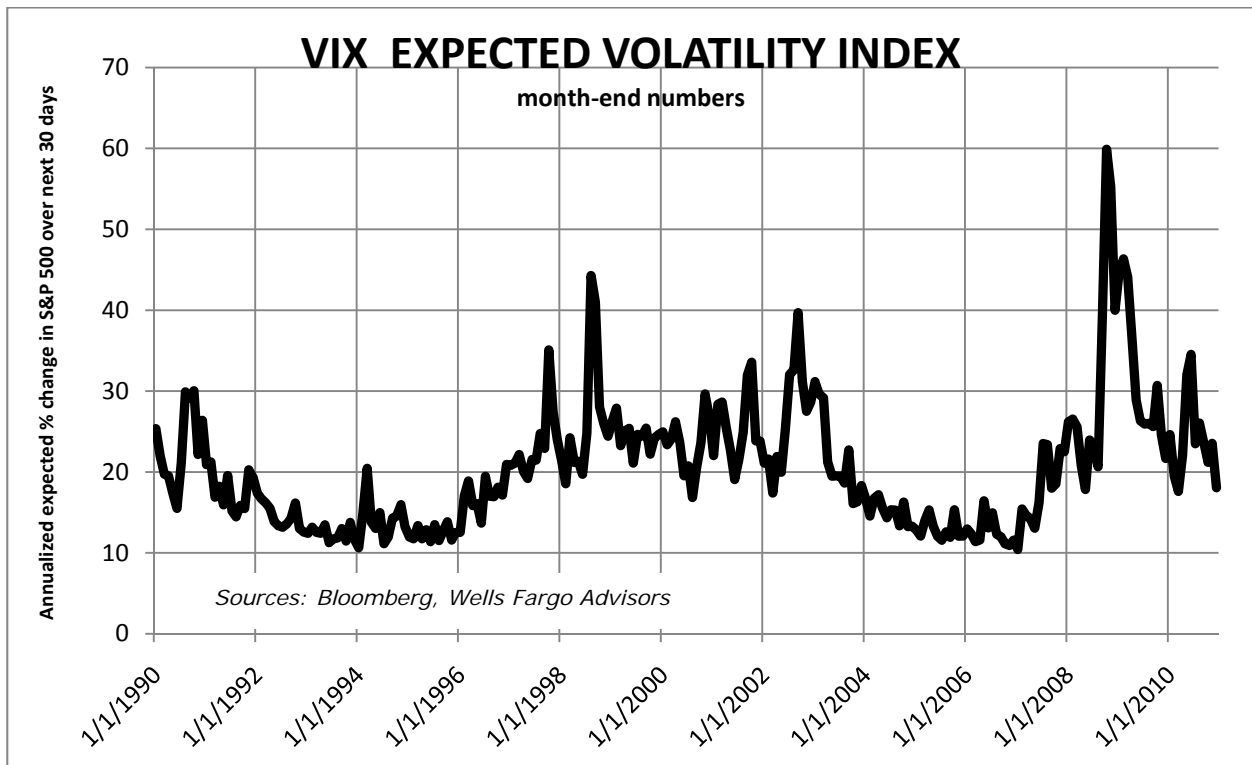
Looking ahead, we expect the economy and corporate earnings to grow at a moderate rate in 2011 as the economic recovery continues. We believe this environment would tend to favor stocks over bonds. The big question is whether the stock market will be more or less volatile in 2011 than in 2010. History suggests that volatility could be lower as the economy continues to heal from the wounds suffered during the recession.

This week's chart looks at a history of expected stock market volatility as measured by the VIX volatility index. This index reflects the expected annualized percentage change in the S&P 500 over the next 30 days. Traders often refer to this measure as the "fear index" because it usually increases when investors are fearful and are bidding up the price of options to protect against potential swings in the market. The chart shows that expected volatility spiked up sharply during the financial crisis and recession in 2008 and also

more recently in 2010 during the European debt crisis. Fortunately, volatility concerns have subsided since then, returning to a rate closer to its longer-term 21-year average of 20.4.

Two factors seem to affect expected volatility the most – unanticipated events and the economic cycle. Unexpected shocks can affect the economy and investor sentiment at any time. However, the impact of unexpected events appears to vary with the state of the economy, increasing when the economy is weak and decreasing when the economy is strong and resilient. It is impossible to know when unexpected events may shock the economy and increase market volatility. Therefore, volatility can increase at any time. But when the economy is healthy, the impact of unexpected events seems to be less than it would be if the economy was weak and suffering from other problems at the same time. That is probably why concerns about volatility diminish as the economic expansion matures.

History can give us some clues about potential volatility risks. Of course, past performance does not guarantee future results. The chart shows that expected volatility has historically increased when the economy is in recession and has tended to subside during an economic expansion. For example, volatility increased in the years around the 1990-1991 recession and then again in the years just before and after the 2001 recession. However, volatility subsided and stabilized at a low level in the mid 1990s and again in the mid 2000s as the economy strengthened and overcame the problems that caused the recessions. This trend toward lower volatility after a recession may be why many investors often return to stocks when they are less fearful and more comfortable taking risk again.



Last year's European sovereign debt crisis caused expected stock market volatility to increase but not as much as it did during the 2008 financial crisis. In other words, the market was tested by the European debt crisis and passed the test. The spike in expected volatility last year was more like an aftershock, following the financial crisis rather than the actual quake itself.

Looking ahead, normal probability suggests that the economy is likely to experience several unexpected events in 2011, and investors should expect the stock market to be somewhat volatile. However, since the economic recovery has been underway for a year and a half, the economy has likely grown healthier and potentially more resilient to shocks than it was during the recession. Therefore, the market may not be as volatile as it has been during the past few years.

In summary, investors who are turning more positive on stocks and more defensive on bonds should remember that equities are historically more volatile than bonds. However, expected stock market volatility appears to be subsiding from the extremely high rate experienced during the recession. Last week, the stock market was very quiet because of light holiday trading. Volatility is likely to increase this month as trading activity returns to more normal levels. Also, the economy and the markets are likely to experience additional aftershocks and spikes in volatility this year because of many lingering problems from the recession. Nevertheless, we remain long-term positive on the economy and the market and expect modest equity market returns in 2011.

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