

Private Client Letter

by John E. Chapman

U.S. Equities Grind Higher

The continuation of the bull market rally in August serves as a textbook example of factors that boost investor confidence in the stock market's potential for further growth. Cyclical sectors led the way, market breadth was strong, long-term treasury yields fell, and volatility decreased. Although sectors that had performed well throughout the year underperformed at the beginning of the month, this situation was more about market rotation within sectors rather than a shift out of the market entirely.

Recent economic data hasn't been particularly strong; however, the economy is still growing, and the Fed looks increasingly likely to start cutting rates in the fall. While there are legitimate reasons to be concerned over the health of the consumer, especially at the lower end, credit card charge-off data has recently shown improving trends. The potential for an uptick in inflation remains the biggest risk for investors, even as the impact of tariffs on consumer prices has proven to be a significantly lower threat than many had originally feared.

The market now enters a new month, having just marked its 20th record close of the year, and has produced elevated equity valuations. Investors are justified in thinking that there is little margin for error heading into what has historically been the weakest month of the year.

Known as the "investor fear gauge," the CBOE Volatility Index (VIX), reflects investors' best predictions of near-term market volatility, or risk. In general, the VIX typically starts to rise during times of financial stress and lessens as investors become complacent. It can be seen as a reliable indicator of near-term market volatility.

Following a significant surge in April following the unveiling of the Liberation Day tariffs, the VIX Index has experienced a historic decline. As measured by the 100-Day Rate of Change of the VIX, investors recently witnessed the third-largest decline on record. While a low VIX generally reflects expectations of market stability, it can also indicate an underappreciation of risk. Complacency, when it comes to investing, often leaves investors vulnerable to sudden market shifts.

Only time will tell if this recent decline in the fear index will be followed by a spike in volatility. Still, this should not be taken as a signal to sell stocks and go to the sidelines. As was illustrated in last month's CCP Thought Leadership article, The Paradox of High Expectations, the risks of mistiming market movements can be significant. History provides us with a well-documented pattern that shows how missing even a handful of the strongest recovery days can meaningfully drag down long-term returns.

What investors should do, however, is anticipate an eventual rise in volatility. Near-term turbulence in the markets can spike quickly – often triggered by surprising reasons. Investor sentiment often exhibits signs of complacency, which is evident in the sharp decline of the VIX Index. Instead of being caught off guard by a sudden market shift, investors should be ready for such changes to occur.

The rally from April's lows has been impressive. At some point, however, we can expect sharper swings in the market as downturns are simply a normal part of the market cycle. We believe that careful attention to diversification and risk exposure can serve clients better than attempting to sidestep downturns. Volatility, when it does return, should be seen as a challenge to navigate rather than a reason to panic.

While September has been the weakest month of the year from a historical basis, October has generally been positive, and November is consistently among the strongest months for U.S. stocks.

As observed in last month's letter, we like many things about this economy. Productivity gains from innovations such as artificial intelligence are almost entirely in front of us. Along with clarity over tax policy, regulatory reforms, and pro-growth initiatives that encourage business investment, we can expect to see equity prices drive higher over time.

Our outlook remains constructive for the economy over the next several years, even as we expect a choppy market along the way.

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