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# A Note on Market Volatility and KAR's Focus

As of 12/20/18

## JUDGING BY STOCK MARKET RETURNS, THIS HOLIDAY SEASON HAS BEEN ANYTHING BUT CHEERFUL.

Stocks have suffered wild bouts of volatility recently, with major stock indices fluctuating between new lows and short-lived recoveries. The S&P 500 Index is down 13.56% quarter-to-date through Wednesday, December 19, 2018, with the day closing on a downtick following the Federal Reserve's decision to raise another quarter point in the benchmark interest rate while projecting a slower pace of rate hikes in the next year.

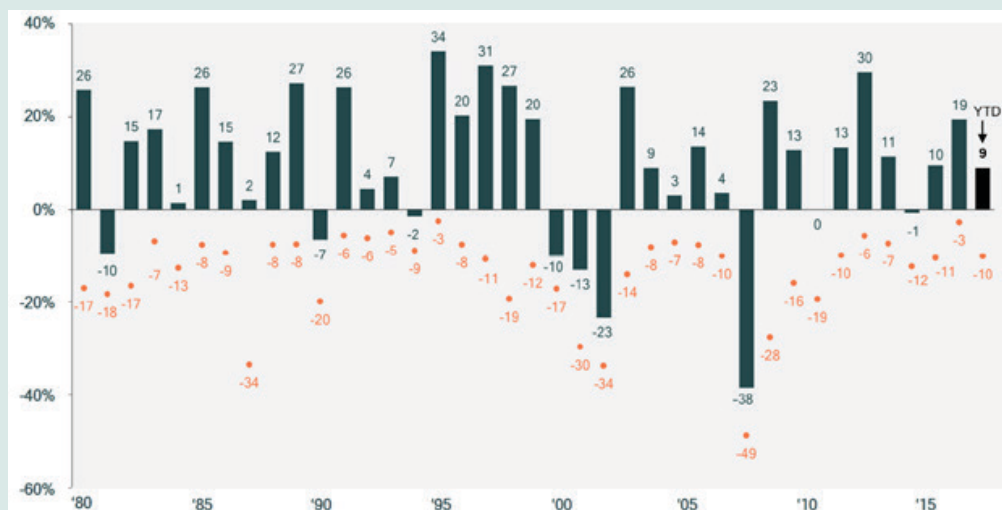
We came into the year thinking that 2018 growth would be pretty strong—at between 2.5% and 3.5%—and we are indeed looking at closing out the year at GDP growth of slightly above 3%. However, what's changed now, and what the market is struggling with this quarter, has to do with the market's perception about growth going forward into 2019.

We are seeing global risks rise on various fronts. For one, what was once hailed as "global synchronized growth" is not mentioned anymore, as Europe and emerging-markets, notably China, have slowed. The U.S. has been a strong pillar of growth for the global economy for some time, but its sustainability, too, is being questioned. The domestic economy appears to have reached peak growth and profitability in the second quarter of 2018. Rising interest rates and a flattening yield curve pose a threat to future growth of equities and the economy. Trade disputes also add to these concerns.

We want to assure you that we are closely monitoring the market and the volatility that it's been experiencing lately. And here are a few things we'd like to point out in light of the recent market environment:

- It's important to know your risk tolerance. If you are investing for the long haul and have identified the appropriate level of risk tolerance for your investments, then we encourage you to stay the course.
- Markets will experience swings, but let us remind you that even in years with meaningful intra-year declines in stock market returns, performance over the long term can still be quite strong.

### S&P 500® Intra-year Declines vs. Calendar Year Returns Despite average intra-year drops of 13.8%, annual returns positive in 29 of 38 years



Source: FactSet Research Systems, Standard & Poor's and J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refer to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar-year returns from 1980 to 2017, over which time period the average annual return was 8.8%. Data as of September 30, 2018. Past performance is no guarantee of future results.

- Rotation among asset classes is common; not all asset classes are going to work in a given year. Part of our job is to navigate the markets to create and maintain the optimal diversification that will meet your long-term financial goals.

2003 - 2017																	
2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	Ann.	Vol.
EM REITs	EM REITs	EM REITs	EM REITs	EM REITs	Fixed Income	EM REITs	REITs	REITs	REITs	Small Cap	REITs	REITs	Small Cap	EM REITs	Small Cap	EM REITs	EM REITs
16.3%	31.6%	34.5%	25.1%	39.8%	5.2%	19.9%	8.3%	19.7%	38.8%	28.6%	2.8%	21.3%	37.5%	11.5%	12.7%	23.0%	
Small Cap	EM REITs	Comdty.	EM REITs	Comdty.	Cash	High Yield	Small Cap	Fixed Income	High Yield	Large Cap	Large Cap	Large Cap	High Yield	DM REITs	Large Cap	Small Cap	REITs
47.3%	26.0%	21.4%	32.6%	16.2%	1.8%	59.4%	24.9%	7.8%	19.6%	32.4%	13.7%	1.4%	14.3%	25.6%	10.6%	11.2%	22.3%
DM REITs	DM REITs	DM REITs	DM REITs	DM REITs	Asset Alloc.	DM REITs	EM REITs	High Yield	DM REITs	EM REITs	Fixed Income	Fixed Income	Large Cap	Large Cap	Asset Alloc.	REITs	Small Cap
39.2%	20.7%	14.6%	24.9%	11.6%	23.1%	32.3%	9.2%	3.1%	18.6%	23.3%	8.0%	0.5%	12.9%	23.9%	2.9%	11.5%	18.4%
REITs	Small Cap	REITs	Small Cap	Asset Alloc.	High Yield	REITs	Comdty.	Large Cap	DM REITs	Asset Alloc.	Asset Alloc.	Cash	Comdty.	Small Cap	REITs	Large Cap	Comdty.
37.9%	18.3%	12.2%	18.4%	1.1%	126.9%	28.8%	16.8%	2.1%	17.9%	3.9%	5.8%	0.0%	11.9%	14.6%	1.8%	9.9%	18.8%
High Yield	High Yield	Asset Alloc.	Large Cap	Fixed Income	Small Cap	Large Cap	High Yield	Cash	Small Cap	High Yield	Small Cap	DM REITs	EM REITs	Asset Alloc.	Cash	High Yield	DM REITs
32.4%	12.2%	1.1%	15.8%	7.0%	-23.6%	27.2%	15.1%	6.1%	16.3%	7.2%	4.8%	3.4%	11.9%	4.6%	1.2%	9.6%	18.4%
Large Cap	Asset Alloc.	Large Cap	Asset Alloc.	Large Cap	Comdty.	Large Cap	High Yield	Asset Alloc.	Large Cap	REITs	Cash	Asset Alloc.	REITs	High Yield	High Yield	DM REITs	Large Cap
28.7%	2.8%	4.9%	19.3%	5.5%	-35.6%	14.8%	14.8%	16.0%	2.9%	0.9%	-2.8%	8.6%	10.4%	-0.6%	14.5%	14.5%	14.5%
Asset Alloc.	Large Cap	Small Cap	High Yield	Cash	Large Cap	Asset Alloc.	Asset Alloc.	Small Cap	Asset Alloc.	Cash	High Yield	High Yield	Asset Alloc.	REITs	DM REITs	Asset Alloc.	High Yield
26.3%	10.9%	4.6%	13.7%	4.8%	-37.0%	25.4%	13.3%	-4.2%	12.2%	0.6%	0.6%	-2.7%	8.3%	8.7%	-1.0%	8.3%	11.3%
Comdty.	Comdty.	High Yield	Cash	High Yield	REITs	Comdty.	DM REITs	Fixed Income	Fixed Income	EM REITs	EM REITs	Small Cap	Fixed Income	Fixed Income	Fixed Income	Fixed Income	Fixed Income
23.8%	9.1%	3.6%	4.8%	3.2%	-27.7%	18.8%	8.2%	-11.7%	4.2%	-2.0%	-1.8%	-4.4%	2.8%	3.5%	-1.6%	4.1%	11.6%
Fixed Income	Fixed Income	Cash	Fixed Income	Small Cap	EM REITs	Fixed Income	Fixed Income	Comdty.	Cash	EM REITs	DM REITs	EM REITs	DM REITs	Comdty.	Comdty.	Cash	Fixed Income
4.1%	4.3%	3.0%	4.3%	-1.6%	-43.1%	5.9%	6.5%	-10.3%	0.1%	-2.3%	-4.5%	-14.6%	1.5%	1.7%	-2.0%	1.2%	3.3%
Cash	Cash	Fixed Income	Comdty.	REITs	EM REITs	Cash	Cash	EM REITs	Comdty.	Comdty.	Comdty.	Comdty.	Cash	Cash	EM REITs	Comdty.	Cash
1.0%	4.2%	2.4%	2.7%	-15.7%	-33.2%	0.1%	0.1%	18.2%	-1.1%	-9.5%	-17.8%	-24.7%	6.3%	9.4%	-7.4%	-0.3%	0.8%

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2017, over which time period the average annual return was 8.8%. Guide to the Markets - U.S. Data are as of December 31, 2017.

Lastly, there are three things we believe need to occur to help the stock market find some stability going forward.

- The Fed has to retreat and slow down on raising interest rates. Our belief is that the ever-flattened yield curve will make future interest-rate increases more difficult to attain for the Fed. After the rate hike yesterday, the yield curve flattened further, as shown below. The line graph illustrates the difference between the 2-year and 10-year Treasury yields and its fluctuations throughout yesterday. It fell quickly after the 2 p.m. EST Fed announcement to close the day lower.

### THE YIELD CURVE 2/10YR BOND SPREAD Intra-day Chart Dec. 19, 2018



Source: Bloomberg

- The trade war between the Trump administration and China needs to ease off. It is starting to become clear now the trade-war rhetoric is affecting both countries. We might still see some volatility and inflammatory Tweets along the way, but we anticipate this will ultimately be resolved positively.
- The domestic economy, which is slowing, needs to stabilize. It will not grow at 3%, but it simply needs to settle in at a lower but stable and positive rate of at least 1% to 2.5%.

In sum, we'll need to see some of these "external" issues—the Fed's push for higher rates and President Trump's threats to trade partners—get cleared away so that we can see how the economy actually does going forward.

There is no question that today's market is not the market we experienced about this time last year. Volatility, while unwelcome, is a normal part of market cycles, and we will have to continue to watch for what shape the economy takes on into the next year.

There is a lot of uncertainty involved in trying to assess stock market and economic events, but the real key to what we do at Kayne Anderson Rudnick is finding high-quality investments and the appropriate asset classes to invest in to meet your individual needs. We believe that is the best protection we can provide to our clients in times of volatility and uncertainty. When you're identifying high-quality companies to invest in over the long term, ultimately you are more likely to see meaningful returns supported by the companies' business results.

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