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STANDARD & POOR'S

Volatility Is Back -- But Is It Here to Stay?

Given the magnitude of moves within the S&P 500, it seems as if investors recently burned by the swiftness of price declines in 2008 are selling first and asking questions later.

The May 6 "flash crash" was a wild aberration from the stability that had dominated the markets in the first quarter of 2010. In many ways it also served as a harbinger of the bumpy ride that investors would experience in the weeks ahead. Indeed volatility is once again dominating the markets, but what are its key drivers and how long might it stay this time?

How quickly emotions can swing from euphoria to despair. Year-to-date through April 23 (the stock market's recent peak), the S&P 500 was up 9.2%, the S&P MidCap 400 had gained 16.9%, and the S&P SmallCap 600 was up 18.6%.[1] Investors enjoyed the ride and breathed a sigh of relief that the U.S. economy was on the mend and concerns over sovereign debt, which triggered a sell-off in January, were resolved. But the markets began to unravel as spring progressed.

May's Downhill Slide

First there was the stunning "flash crash" on May 6 -- a one-day event that resulted in a 9.6% intraday swing in a handful of U.S. stocks. While in retrospect this event was an anomaly that revealed weaknesses in the mechanics of our trading system, it sent shock waves among investors that once again created uncertainty in the U.S. capital markets.

By May 31, although all three U.S. benchmark indexes were higher for the year, large-cap stocks had fallen 10.5% from their April 23 high, while midcap and small-cap stocks had each declined about 10%.[2]

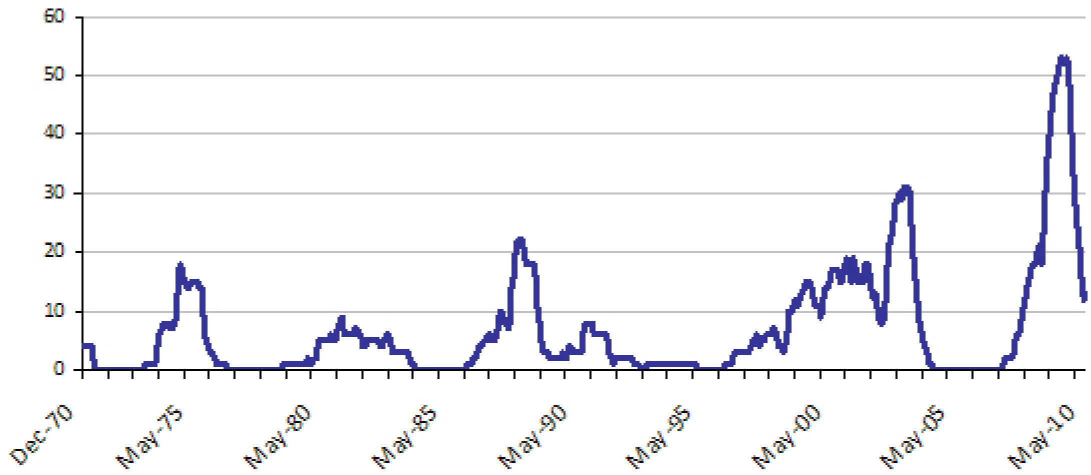
The potential causes of current market volatility are numerous: the European debt crisis and the declining euro; the crisis unfolding daily around the Gulf oil spill; tensions brewing between North and South Korea; and anti-government riots in Greece, Thailand, and other global hot spots all seem to dominate the evening news. Perhaps the most unnerving factor of all is the uncertainty about how these factors might play out against the backdrop of a fragile economic recovery -- both here in the United States and around the globe.

Sell First, Ask Later

Given the magnitude of moves within the S&P 500, it seems as if investors -- recently burned by the swiftness of price declines in 2008 -- are selling first and asking questions later.

For instance, May 4, May 6, and May 20 were the three most recent times that the S&P 500 dropped 2% or more in a single session. In the past 12 months (ended May 31), the S&P 500 fell by 2% or more 13 times vs. an average of seven times per year since 1970.[3]

Volatility on the Rise



Source: Standard & Poor's Financial Communications. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

The question now on everyone's mind is whether the volatility currently roiling the world's financial markets will subside any time soon. It's doubtful. While world equity markets have weathered past financial crises with only modest near-term price declines, today's concerns seem to be deeper and more widespread. Many expect the euro to fall to parity with the U.S. dollar, which could open the door to a potential double-dip recession in Europe that could drag most worldwide economies along with it.

Standard & Poor's believes that while the fragile global recovery is at risk, the world is not likely to slip back into a recession. Currently, S&P forecasts U.S. 2010 real GDP growth at 3.3%, while IHS Global Insight sees global GDP growing by 3.7% in 2010.[4]

Takeaways for Investors

It appears that the current bout of market volatility will likely be with us for some time. Instead of reacting hastily to the market's short-term swings, try to take a long-term view and keep the following strategies/perspectives in mind.

- **Keep declines in perspective.** Stock market declines are a lot more common than one might think. According to S&P historical data there have been 18 corrections (including the current one) since 1946 that posted declines of 14%, on average, and took about four months (calendar days, not trading days) to run their course. Once the correction touched bottom, the S&P 500 took only four months to get back above the pre-correction level.[5]
- **Don't panic.** Don't sell into a rapidly declining market and don't buy into a rapidly rising market. You'll just be following the herd and locking in losses. Panic selling also runs the risk of missing the market's best-performing days. You never know when the market is going to shoot up, so staying invested and not giving in to panic can really make a difference.
- **Review your goals, risk tolerance, and investment mix.** Does your portfolio's asset allocation -- your mix of stocks, bonds, and cash equivalents -- accurately reflect your needs? Have you adequately diversified by spreading your money among different investments to potentially reduce risk?

[1-4] Source: Standard & Poor's, *The Outlook*, May 26, 2010.

[5] Source: Standard & Poor's, *Global Equity Strategy*, May 24, 2010.