Recent Market Turmoil – Now What?

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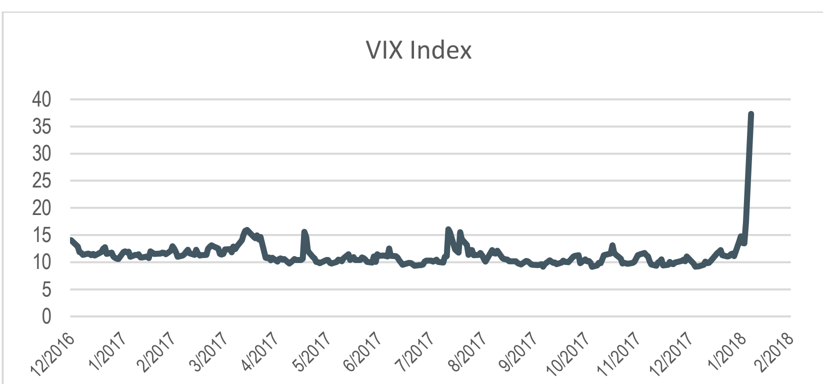
Given the unusual market action over the last couple of weeks, we thought you would be interested in SSI's take on recent events, along with our updated outlook.

Investment Environment

The stock market has been on a historic run with the S&P 500 rising over 60% in less than two years (Feb 11, 2016 – Jan 26, 2018). The favorable market environment has been driven by accelerating global economic growth, strong corporate earnings, a favorable business backdrop, benign inflation, and accommodative monetary policy by our Federal Reserve and other central banks. During this nearly two year period, there has not been a 10% correction and equity volatility has steadily declined. In fact, S&P volatility, as measured by the Cboe Volatility Index ("VIX"), was under 10 for much of last year, which is about half of the long term average. The low and steady VIX levels led investors to make a significant investment in "short volatility" investment strategies, which profited from low and further declining volatility. These strategies were quite successful in 2017 and assets ballooned to approximately $2 trillion, according to some estimates.

What happened?

During January, the yield on the 10-year U.S. Treasury rose from 2.4% to 2.7%. Rising rates didn't prevent the S&P 500 from rallying an additional 5.7% in January, but the VIX Index, which usually moves in the opposite direction of stocks, rose to 15 late in the month. This was the highest level on the VIX since last August. On Friday, February 2 the January jobs report showed an upside surprise in average hourly earnings. This raised concerns about rising inflation which pushed the 10-year yield over 2.8%, contributed to a 2.1% sell off in the S&P 500, and a further increase in the VIX to over 17 (please refer to below graph).



Source: Bloomberg

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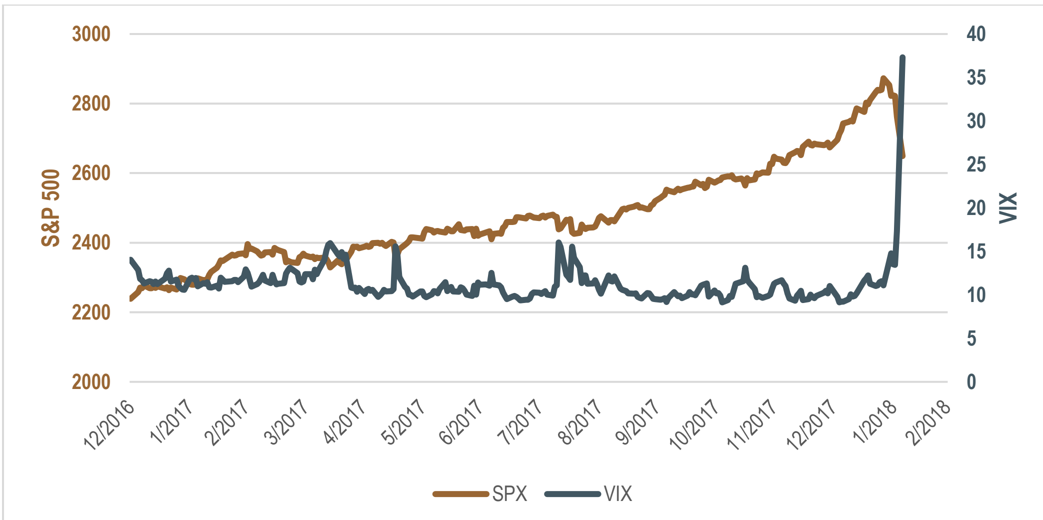
Although a 2% market decline is not unusual in a historical context, given the low volatility prevalent in recent times, it appeared to be enough to initiate some forced selling by systematic investment strategies, of which the VIX is a part of. Other such volatility strategies include risk parity, target volatility, and trend following. This selling caused the stock market to decline during trading on Monday, February 5th, and contributed to a further increase in volatility. As volatility increased, “short volatility” strategies were forced to reduce exposure by short-covering through VIX futures, closing-out their short position and minimizing further loses. This pushed the VIX to extreme levels over 35 (as shown in the graph below), and caused the market decline to accelerate in the afternoon, resulting in a more than 4% decline on the S&P 500 for the day.



Source: Bloomberg

SSI Outlook

In spite of the recent turmoil, we remain constructive on the prospects for the equity markets. The dramatic decline in early February appears to be a temporary risk event, driven primarily by technical factors and amplified by investor positioning and forced selling. The impact that “short volatility” strategies had on the overall stock market over the last few days was alarming, but their potential influence has already been greatly diminished and their viability going forward is very much in doubt. Extreme loss in selected short volatility strategies has already caused Credit Suisse to liquidate XIV, their inverse volatility ETN, and other asset managers will undoubtedly follow suit.

At this juncture, the key drivers of the stock market remain generally favorable. The economic backdrop is very strong with most global indicators pointing toward a continued acceleration. The business environment is the healthiest it has been in quite some time, as the new tax plan, reduced regulations and positive business sentiment are all contributing to robust corporate earnings. On the negative side, inflation concerns have risen based primarily on average hourly earnings, which were above expectations in the January jobs report. It is important to note that other inflation indicators

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are not seeing a similar pick up, and inflation expectations across the financial markets have risen only slightly.

Although central banks have begun pulling back, interest rates remain low by historical standards and well below the neutral rate. As liquidity is withdrawn through higher rates and/or less quantitative easing, we would expect stock market action more in line with historical norms. While this means more volatility, including pullbacks and even corrections, there is little reason to expect an extended downturn or bear market in the foreseeable future. As a result, we would expect signs of stability in the equity markets relatively soon. If this does not materialize and other key drivers turn negative, we are prepared to take defensive steps in client portfolios.

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