AGF's thoughts on the ongoing volatility

What happened?

After years of stubbornly low inflation across global markets, we are suddenly starting to see signs of this ticking higher, triggering a long-awaited selloff and a surge in volatility. As a result, panic has spread amongst investors in fear that financial markets may be overheated. In our view, the selloff has been driven by three compounding factors.

Rotation – weakness began last week as pension funds rebalanced out of equities and into bonds after a strong rally in equities in January. According to Morgan Stanley, Goldman Sachs and Credit Suisse, the volume of pension rebalancing that was expected to occur at the end of January was estimated to be one of the largest on record.

To illustrate this simply, consider a typical globally invested 60/40 balanced fund. Equity markets moved sharply higher in January (the S&P 500 was up 5.6%in January alone[1]), causing a drift away from the strategic asset allocation mix. As a result, pension funds were forced to sell equities and buy bonds in order to re-establish the desired mix. Of vital importance here – this selling of equities is not fundamentally driven, rather technically driven.

Robot trading – compounding the outflows, this large scale of equity selling alerted circuit breakers on algorithmic trading, triggering mounting selling from trend-following strategies. Not unlike the pension outflows, such strategies trade strictly on market technicals without considering context of the greater economic backdrop.

Retail – our channel checks across trading desks is that the selling has been overwhelmingly retail, and that institutional market participants have been net buyers. Indeed, we saw several robo-advisors forced to shut down operations on Monday, leaving investors unable to execute trades due to overwhelming activity. In our view, without the help of an advisor to talk investors through such market events, we are seeing an increase in panic selling, only exacerbating the situation.

Our thoughts on the current environment

If there is one point we wish to drive home – **this selloff is not fundamentally driven** and this is not a repeat of 2008 where we witnessed a credit event and a housing-related issue (sub-prime mortgage market collapse). In fact, fourth quarter earnings season in the U.S. has been exceptionally strong, with the S&P 500 on track for the largest number beats this cycle. We still have an environment with coordinated global economic growth, and as long as market volatility does not erode broader confidence, the underlying fundamental picture remains supportive. If anything, we see such extreme bouts of volatility as an opportunity for active managers to capture alpha in oversold positions.

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[1] Bloomberg

Market corrections are normal, and in fact healthy. 5% corrections occur on average three times per year. In the past 30 years, there have been 30 months during which global equities have fallen by at least 6.3% in a stretch of only six business days, as they have done recently. Importantly, markets took only four months on average to recoup the losses, and equity market returns were positive 77% of the time.

Equity market's falls in six days and subsequent returns

Six-day returns	1 week	1 month	3 months	6 months	12 months
Between -2.0% and -3.0%	0.2%	0.4%	1.2%	1.8%	2.9%
Between -3.0% and -4.0%	0.2%	0.5%	2.0%	3.1%	5.2%
Between -4.0% and -5.0%	0.6%	1.1%	3.1%	3.6%	5.9%
Between -5.0% and -6.0%	0.4%	1.1%	3.4%	4.9%	9.1%
Between -6.0% and -7.0%	**0.6%**	**1.1%**	**5.1%**	**7.4%**	**13.9%**
Between -7.0% and -10.4%	0.1%	2.9%	7.6%	10.7%	19.6%
Between -10.4% and -13.7%	5.9%	1.1%	-0.5%	4.4%	26.7%
Between -13.7% and -17.1%	-5.7%	-7.2%	-9.9%	-18.8%	11.9%
Between -17.1% and -20.4%	-2.6%	-2.6%	-1.0%	-9.7%	20.5%

Source: BofAML Global Quantitative Strategy, MSCI, ExShare, Factset Data since 1988

Within fixed income, the 10-year U.S. Treasury yield was weighed down by double-digits on Monday following the sharp move in equities. Though this was not the case in last week's selloff, which saw yields move higher alongside stronger economic data. Typically the market has exhibited a negative correlation between stock prices and bond prices, whereby as equities sell off, bond prices rise (or bond yields fall), benefiting from the safe-haven flows into bonds. This trend resumed yesterday, and is breaking down again today. However, longer term we expect this trend to remain in-tact, at least until yields approach the 4% level (on the U.S. 10-year).

What's next?

Going forward, the market is eyeing 3% as the target for the U.S. 10-year Treasury yield. We are currently at around a 70 basis point real yield in the U.S., which is close to the long term average. However, if we build in another 20-30 basis points of inflation premium, a 3% nominal U.S. 10-year Treasury yield is certainly in sight. We will continue to monitor yields as we could temporarily move even higher, depending on the economic data and market expectations.

We remain underweight duration in all of our fixed income funds and short the long end of the yield curve, which will help if yields do move higher. High yield spreads have widened about 15 basis points in a short period of time, which is fairly substantial, though we expect the market to remain supported if growth trends continue and equities eventually stabilize.

Overall, the AGF Asset Allocation Committee remains favourably tilted towards equities as the fundamental economic environment remains positive and growth across global markets appears well positioned to continue. Cash levels are high and company balance sheets appear healthy enough to withstand a downdraft in equity markets. We view the market volatility over the past week as truly a technical move and potentially healthy for further market growth over the full market cycle. We believe markets will fully recover to new highs, though we stress a disciplined approach will be key, as a recovery from this correction will likely take months, not weeks.

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