UBS Asset Management Flash commentary

February 2018 | Technicals overpower fundamentals

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Why are equity markets selling off?

The catalysts for the sell-off in risk assets over recent days have been the rise in 10y bond yields globally over recent months and more specifically, the significantly higher than expected Average Hourly Earnings figure in the US on Friday. To investors cosseted and emboldened by a low inflation and low rates environment for so long, there seemed to be a sudden and violent repricing of the probability that higher inflation and higher rates may be on their way.

After a protracted period without any major drawdown, the equity market reaction has been sudden and severe. The S&P 500's 4.1% fall on Monday was the largest one-day drop in over six years, and the 20 point spike in the widely-watched VIX Index in the US was the largest one day percentage or absolute rise in the VIX's history. While other equity markets have also fallen sharply, the moves appear to have been most extreme in the US. Ironically given fears about the impact of higher bond yields, the risk-off environment has seen yields on 10yr US Treasuries pull back relatively sharply. Significantly, credit spreads have only widened marginally despite the scale of the equity sell-off

In our view, the contrast in risk asset behavior and the timing of the equity price action in recent days – with the sell-off accelerating materially into the market close – is consistent with the rebalancing of systematic trading strategies, risk parity funds and exchange traded products that invest in short-term VIX futures in particular. The popularity of low and short volatility exchange traded products, some leveraged, has increased dramatically over the past few years as investors seek any edge to boost returns. This reinforces our belief that while the initial catalyst to the sell-off was fear of a step change in the overall inflation and rates regime, that the subsequent risk-off momentum has been largely driven by technical rather than fundamental forces.

What is the outlook from here?

It remains to be seen whether these technical forces will abate quickly. At the very least, events over the past few days serve as a salutary reminder of both the dangers of crowded positions and of the power of technical forces when combined with consensual positioning. But our view that the sell-off has been predominantly driven by technicals rather than fundamentals is a high conviction one and our central thesis remains unchanged. Importantly, we do not believe that the very strong global growth and earnings backdrop has suddenly evaporated. We see bond yields in developed markets ticking higher as growth expectations rise, global output gaps close and as wage growth rises from its current very low base. We see a violent shift higher in global bond yields as unlikely in the context of powerful demographic drivers and the on-going expansion of central bank balance sheets globally.

We believe it would take nominal 10yr US Treasury yields between 3.5% -4% with no change to growth and inflation expectations to restrict growth or to start impacting the overall earnings environment in a meaningful way. While equities are selling off it is worth remembering that they are doing so at a time when global monetary policy remains accommodative and as global economy continues to enjoy a stronger than forecast expansionary impulse that is broad-based by geography and by economic sector. In our view, the rise in corporate capital expenditure reduces the global economy's reliance on consumption and gives us confidence that global recession risks are low.

Against this backdrop, corporates are also delivering stronger than expected profits growth. We see scope for further upside surprise in earnings across developed and emerging markets as tax reforms boost capex and capital returns to shareholders in the US, and as operational gearing kicks in as the recovery accelerates in Europe, Japan and in Emerging Markets.

Given valuations are now more attractive, we will be looking closely at whether there is now an attractive opportunity to add risk to portfolios.

An equity market perspective
Kevin Barker, Senior Equity Specialist

The scale of the sell-off is not unusual after such a prolonged period, especially in what has been a particularly long duration bull market, and following a period of unusually low volatility.

However, given earnings momentum was strong throughout 2017 we see no reason to believe this has been stalled by recent events. So far we have seen a technical sell-off, driven largely by futures and most likely exacerbated by hedge funds and Exchange Traded products/funds. If this period of dislocation continues we may see further technical forced selling which could increase volatility across sectors and stocks. With valuation spreads currently quite narrow across markets, a widening of volatility would create more opportunities for stockpickers.

Looking across our equity strategies there has been no meaningful impact across funds relative to benchmarks, but we will be monitoring events closely over the coming days and weeks.

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