Investment Insights

Sell-Off Accelerates; “Short Vol” Flash Crash?

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Highlights

- The equity market sell-off which began last week continued in earnest Monday, with most major indices down 3% to 5%. While the equity market decline over the past week has been notable and steep, particularly Monday afternoon, the peak to trough S&P 500 decline (8%), still falls short of what is normally classified as a “market correction” (-10%).
- The selling pressure Monday afternoon was particularly notable (the Dow Jones Industrial Average sank more than 1,100 points while the VIX index peaked for the day at 38), and our initial analysis indicates that this was likely driven by algorithmic-related trading (including “short volatility” strategies) which may have led to a so-called “flash crash”, similar to what equity markets experienced in 2010, but to a lesser degree.
- What made Monday different than the price action we saw last week is the behavior across asset classes. During last week’s drawdown, there was selling pressure on both equity and fixed income markets. In today’s sell-off, we experienced a more traditional response across asset classes, with a flight to safe haven investments, such as high-grade fixed income, gold, and currencies such as the yen and dollar.
- The large rise in equity market volatility over the past week has led to a change in expectations for Fed tightening over the near term, with investors pricing in less of an expectation for a rate hike at the March FOMC meeting than they were last week. This flattening in the path of the policy rate will eventually help to support risk sentiment going forward.
- At this juncture, we see no reason to change asset allocations. With a still-very strong global economic backdrop, solid corporate earnings and central banks aware of feedback loops from markets to the economy, we expect this correction will prove relatively short lived and truly an opportunity to invest.

We have highlighted over the past several months that the unprecedented levels of low volatility that came to characterize equity markets for much of 2017 would eventually come to an end, and over the past several days, that has certainly been the case. Unfortunately, when volatility becomes compressed to the degree in which it was in early January, when the move finally does occur it’s like a spring being released, and the price action can be quite volatile, as was definitely the case Monday. The U.S. equity fall was the largest seen in 6 ½ years, and the spike in the VIX volatility index the largest since August 2015.

Last week’s initial declines were sparked by fears over the potential impact of higher interest rates on corporate profitability. In that vein, we saw bond yields rise alongside falling equities.

The sell-off changed personality Monday. Price action became more consistent with a “risk off” mentality. Five-year U.S. government bond yields are currently trading about 15 basis points lower than their closing levels from Friday as the aforementioned “flight-to-quality” trade has taken hold. Investors, potentially tactically, are allocating money away from equities are likely parking money in bonds. Meanwhile, the probability of a March Fed hike, which reached 90% as

of the end of last week, has started to decline. It is less likely that the Fed would go ahead with a rate hike if this level of volatility persists, the so-called "Greenspan put," to which investors so often refer. (Interestingly, Monday marked Jerome Powell's first day as Federal Reserve Chairman, following an interview this weekend with outgoing Janet Yellen who said she found market valuations "elevated.")

Monday's sharp afternoon selloff, in our view, likely reflected another factor of note: "short volatility" position unwinding. Recent years have seen a large increase in both institutional and retail capital invested in strategies that would benefit if actual market volatility proved less than implied volatility. Many of these strategies are algorithmic, meaning that market levels and momentum would generate buy and sell signals. As the VIX index rose in recent days, and especially Monday at a rapid pace, it may well have signaled to some of these quantitative strategies to buy more volatility, exacerbating the move. At the same time, investors losing money in these strategies may have looked to more liquid, underlying equity markets to hedge — that would help explain the sudden drop in the S&P 500 toward the end of the day.

These sorts of position unwinds are difficult to measure with precision. We cannot say with confidence if this selloff will last another day or week or longer. We do know that these programmatic strategies will see signals "flip" at certain points when selling is deemed overdone. Just as the selloff seemed sudden, a recovery could also be sudden. Another wild card will be policymakers. Will Federal Reserve officials (or policymakers overseas) try to calm markets, appreciating the increasing links between equities and underlying economic and corporate health? Tuesday, the Fed's Bullard is set to speak and Wednesday, Evans, Kaplan, Dudley and Williams are all slated to speak. One can imagine Fed officials debating internally how to best manage this — some volatility in markets is probably welcomed but an option market with no liquidity that can fuel more systemic risks is not.

As this equity selloff continues, investors will likely price in a less hawkish Fed. Lower bond yields, along with shifting "algo" signals, should help equities find their footing. More medium term, we continue to monitor the slight pick-up in inflation seen in various metrics, but we believe the underlying strength in the economy remains an important offset.

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