TD Wealth

Market correction

Looking for a place to happen

Market Insights

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Wealth Investment Office

Market correction: Looking for a place to happen

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In late July we published our latest edition of Portfolio Strategy Quarterly (PSQ), entitled "All is quiet?" In it, we focused on the peculiar calmness that prevailed at the time, giving rise to a singular question: How can financial markets be so quiet amid war, political upheaval and the AI revolution?

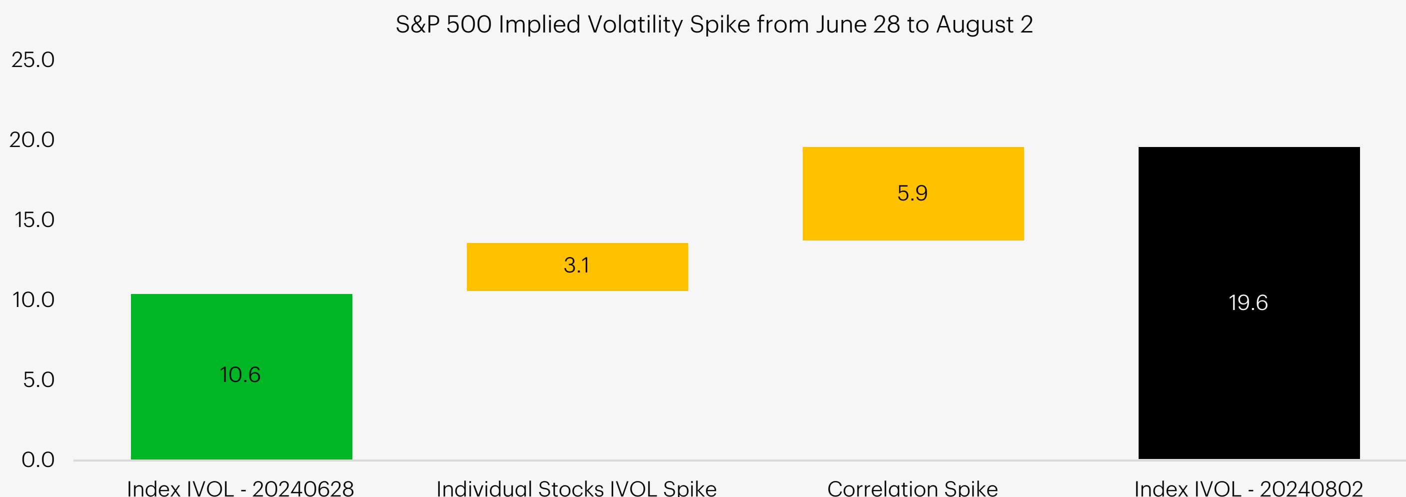
Our analysis led us to a few key factors: (1) asset valuations were high by almost any traditional measure; (2) leverage had reached historical highs, surpassing levels seen in previous cycles; and (3) credit spreads remained very tight, also near all-time lows. Our conclusion was that, while heightened risk sentiment may suggest heightened volatility, in fact the historic market conditions we were witnessing had led to extremely low correlations within the S&P, thereby creating a kind of counterbalancing of extremes:

> *"The takeaway here is that correlation between stocks within the S&P 500 index has fallen to a rare, historical low. This very low correlation, or movement, within the stocks inside the S&P 500 brought down volatility of the index as a whole. At the end of June 30, 2024, the S&P 500 had not declined by 2% or more for over 350 days — the longest since February 2018.*
>
> *"As a reminder, when this period of relative calm ended, volatility roared back to life, forcing the Fed to end its policy of monetary tightening at the time. We are not suggesting that this is imminent — periods of low volatility can last longer than you think — but expecting the current calm to last indefinitely, and allocating accordingly, is unwise for investors who want to grow and protect capital."*

In trading on Monday, August 5, 2024, the VIX spiked to an intraday high of 65.7 — a level only exceeded during the global financial crisis and the early days of Covid. Figure 1 is an update of the implied volatility chart found in the PSQ. The chart shows how the spike in individual stock volatility and the normalization of correlation among individual stocks both contributed to the jump in implied volatility of the S&P 500 from the end of Q2 to August 2nd.

Clearly, things are no longer quiet.

Figure 1: No longer quiet



Source: Macrobond, Wealth Investment Office as of August 2, 2024

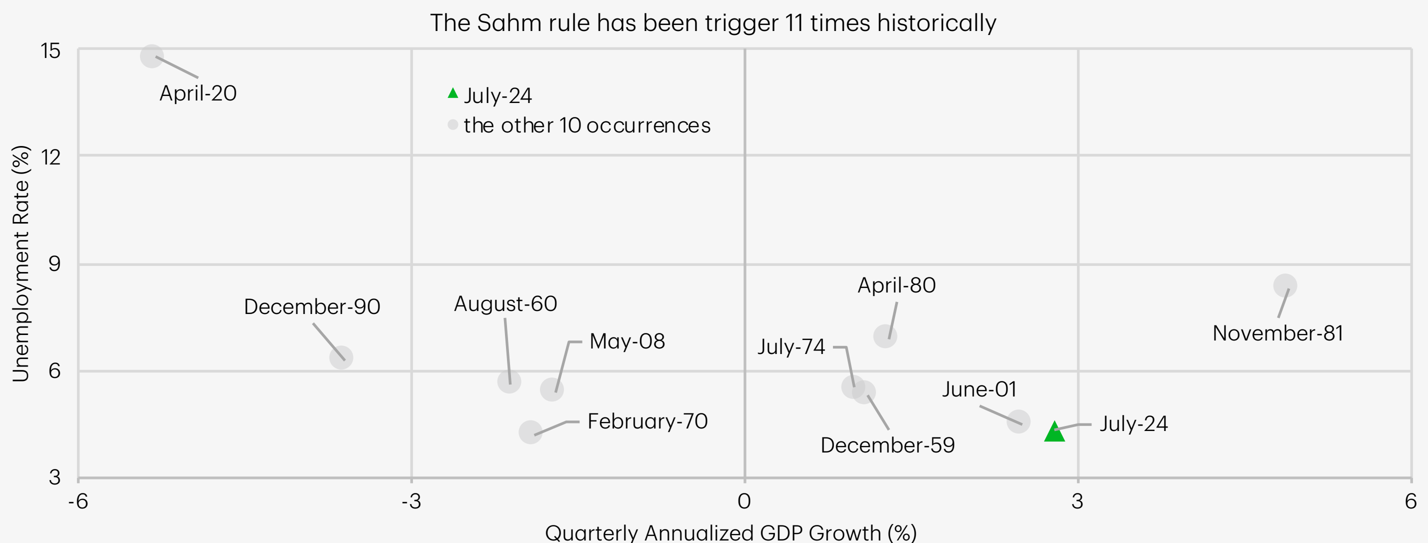
Further, we suggested in the PSQ that markets were quiet because investors were so fixated on inflation, consumer spending and employment — all of which suggested that the Fed was well on its way to achieving the exceptionally rare "soft landing." Markets had taken for granted that inflation would come down to earth while the economy continued to expand.

Then, July's non-farm payrolls report was released, revealing that the unemployment rate rose 20 basis points, to 4.3%. This triggered the so-called "Sahm Rule," which links the start of a recession to when the three-month moving average of the jobless rate rises at least half a percentage point above its low over the past 12 months.

Although the jobs report is striking, the market's reaction says less about the economy than it does about the head space investors find themselves in. This was a market looking for a place to happen; the report was merely a spark set loose in a tinder dry forest.

The worry from here is that, if the job market continues to weaken, it will translate into a further pullback in consumer spending, creating a downward spiral between employment and spending — as is the case for China currently. It should be noted, however, that while the Sahm Rule has been triggered 11 times historically, the economy this time is in better shape than in all the other instances (Figure 2).

Figure 2: Reality check on the U.S. economy



Source: Macrobond, as of August 2, 2024

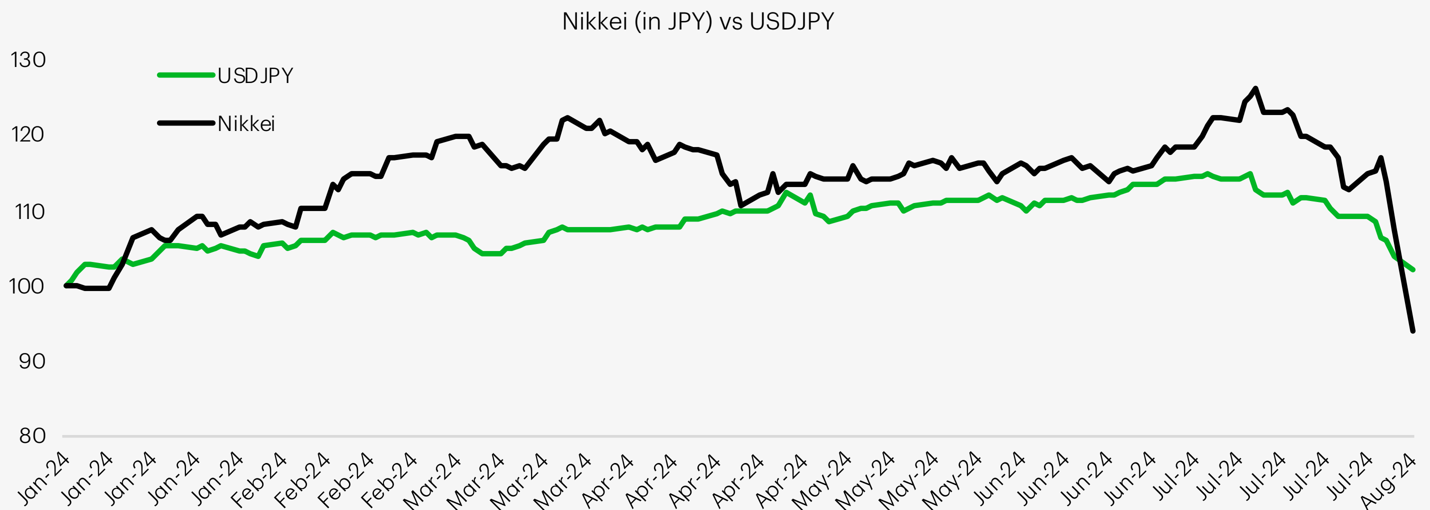
For us, it's hard to be surprised that we are seeing a correction; perhaps the bigger surprise is that it had not happened sooner. In our PSQ, for example, we wrote the following:

> *"It is prudent for investors to rebalance their portfolios to target weights following the massive shift in allocation across asset classes and within each asset class. Investors should also ask whether the current portfolio is truly diversified, especially given the heavy influence of Magnificent Seven stocks in U.S. equity indices."*

Complacency hasn't been limited to U.S. equities either. Take Japan, for instance, where dramatic divergence from U.S. monetary policy has led to huge market swings. In Q1, the Nikkei 225 rose a stunning 21.5%, only to fall 17%, so far, over the course of two days in early August. The Bank of Japan's ultra-accommodative policy and the consequent weakening of the yen seemed to be a sure trade, which benefited Japanese equities due to the economy's significant export exposure — another sure trade for the first half of 2024.

But while the weakening yen may have lifted foreign-denominated investments, it also lifted inflation. It was another tinderbox waiting to spark — and spark it did, when the BoJ pivoted hawkish last Wednesday, resulting in the worst trading day for the Nikkei since 1987. Another wild card may be the possibility that the market pullback leads the BoJ to reconsider. We have seen early signs that the market is pricing down the possibility of a future hike over the next 12 months after Monday's selloff (Figure 3).

Figure 3: End of Japan's complacency



Source: Macrobond, as of August 5, 2024

Currently we are neutral cash, neutral fixed income (giving up a little return on duration but protecting against a breakout in spreads), neutral equity and neutral alternatives.

Neutral is cautious. We were cautious going into this and we remain so. However, we also wrote in the PSQ that we didn't think that this would turn into anything more sinister. We continue to hold this view. This period of increased volatility will pass. There are many positives in the financial markets:

1. **A recession in the United States is not imminent.**
    a. **The labour market may be slowing, but on an absolute basis it remains solid.**
    b. **The advance estimate of Q2 GDP was very strong.**
    c. **We have been waiting for consumer spending to slow; when this happens, it will not be a surprise.**
    d. **The earnings outlook for U.S. companies is still solid and overall Q2 results and guidance remain supportive.**
2. **Financial conditions remain loose.**
3. **Global inflation continues to fall.**

Importantly we concluded our PSQ with this thought:

> *"Extended periods of market calm often end with a reality check that will be reflected in the equity market volatility index (VIX), the bond market volatility index (MOVE) and the currency market volatility index (CVIX). Peace time doesn't last forever. Being mindful of that, sticking to your process, staying diversified and adapting to the environment around you is always the best course of action."*

We continue to think this is the best approach. It's not what you do in the middle of a correction that matters, it's how you prepare for it.

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