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Elston Insights

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Market shake-out: what's going on?

- Weak payroll data raised fears around recession
- Tech sector concentration led the way up – and down
- After a prolonged absence, volatility has returned

What's happened in the markets

A weaker than expected US payroll number once again raised the spectre of "recession risk". All year, upgrades to economic growth estimates suggested that the US can engineer a "no landing" or "soft landing" meaning that economic growth would not be derailed by higher interest rates.

The latest payroll data – a measure of employment activity by businesses – suggests that growth may be slowing after all and perhaps the Fed has held interest rates too high for too long.

The doubt creeping into the market has been coupled with the high valuations in the US tech sector driven by the boom in Artificial Intelligence spending. Whilst tech sector earnings have grown spectacularly compared to the rest of the market, there is a risk that valuations could potentially de-rate as earnings growth slows. The high level of concentration of the tech sector within the US equity index and the high weighting of the US within global indices means that the sell-off in tech also affects the US equity and global equity benchmarks.

An economic slowdown would also be negative for commodity prices such as oil. On a separate note, recent Japanese Yen strength has led to a correction in Japanese equities and is also reversing the so-called "carry trade" where institutional investors could borrow cheaply in yen to invest in risk assets. Any rapid or forced "deleveraging" (selling assets to pay down borrowing) could exacerbate the size of market swings.

The combination of these three drivers has increased market volatility and selling pressure on the markets. Indeed, market volatility has been uncharacteristically low for a prolonged period since end October as markets rallied expecting Fed rate cuts, improved economic growth and the surge in tech stocks. The return of volatility has come suddenly, but as it stands, this looks like a re-rating, rather than a systemic shock (like Covid, or the Financial Crisis).

Fig.1. Volatility has been uncharacteristically subdued since end October 2023

What has proven resilient

Although the US equity market is the main driver of global equity markets, there are some areas within a multi-asset context that have proven resilient, such as:

- US Equities: within US equities, small caps and equal weight strategies have delivered better relative performance compared to traditional "passive" index exposures in this downturn. Careful consideration of the structure of the US equity portfolio remains key.
- UK Equities: an inherent value bias, lower valuation levels and the tech-free nature of the UK equity market has generally been a hindrance over the last decade, but in times like these it's a "diversifying" help. Like in 2022, April 2024 and July 2024, the UK equity market has been up when the US is down.
- Alternatives: assets such as Gold have proved resilient both to inflation and geopolitical risk. Property securities have also performed well recently on prospect of lower interest rates.
- Bonds: the potential for declining policy rates is supportive for Bonds, whose values move in the opposite direction to interest rates. Longer duration bonds, which are more sensitive to a change in interest rates, are looking like a safe-haven once again as yields are attractive, real yields are positive, and have greater benefit from any decline in policy rates.

What to do next

We don't expect the Fed to step in with an early policy rate cut from a monetary policy perspective. But if the market shake-out threatens financial stability (e.g. creates or uncovers systemic risk in banking or financial system), then a targeted intervention is always possible.

We expect this current bout of volatility to continue in the near-term as markets reprice the risk of a recession and the scope and timing of Fed rate cuts. Volatility has been uncharacteristically subdued. Its sudden return although dramatic, is what well diversified, resilient portfolios are designed to withstand.

In summary, i is worth considering a consistent approach below:

1. Stay invested: Long-term investing means accepting periods of market volatility as the flipside of above-cash long-term returns.

2. Stay diversified: by diversifying within and across asset classes, portfolios risks can be less than the sum of their parts.

3. Stay adaptive: an adaptive approach within and across asset classes means that portfolios can be more resilient to near and medium-term volatility, compared to a "set and forget" static allocation approach.

Putting capital to work

For investors who are looking to reinvest into markets out of cash and money market funds (where yields will continue to decline in line with Bank of England policy rates), any short-term stress in the market could be a useful entry point as part of a phased re-investment plan.

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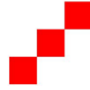

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