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IS A BEAR MARKET ON THE HORIZON?

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Last week, global stock markets went through their most pronounced downturn in more than six months, before a moderate rebound ensued towards the end of the week. The S&P 500, which had set an all-time high this summer despite higher interest rates in the US and mounting trade tensions, has suffered a 5%[1] decline throughout this month up to October 12th. As of that date, the S&P's downturn has taken the index back to early July levels. Many non-US markets still had not fully recovered from the downturn in February in USD terms, and returns in October have sent them further in the red. The MSCI World ex-US and MSCI Emerging Markets were down 11% and 20%[2], respectively, through to October 12th from late-January highs. In a flashback to the market turbulence of February 2018, the VIX volatility index, commonly known as the 'fear gauge' of Wall Street, spiked to nearly 25, although it remained well below 37[3], which was the level hit in February.

Source: Thompson Reuter Data Stream, Mercer Analysis

The previous high-flying technology sector was hit particularly badly. The tech-heavy NASDAQ composite dropped nearly 7%[4] this month up to October 12th.

Many analysts are pointing the blame at rising bond yields as the reason behind the latest sell off. Following rising optimism in the US economy's strength last week, the US 10 year government bond yield soared to a seven-year high of 3.23%[5] in the first week of October, as investors prepared for further rate rises from the Federal Reserve. This move in bond yields may have been sufficient enough to alarm equity markets. However, rising yields on their own probably were not the sole point of blame for this sell-off.

In February, when rising yields caused a short sell-off, these pressures were exacerbated by the collapse of two exchange-traded funds that shorted VIX futures on a bet on the stock markets remaining calm. When volatility spiked, these funds and other traders were forced to cover their positions, causing volatility to increase further. A similar concept might have been behind the sell-off this week. Data from the Commodity Futures Trading Commission indicate as far, that speculators net short position in VIX futures reached levels comparable to January. In addition, risk management strategies that reduce equity exposure as volatility rises and markets fall have grown popular since the financial crisis, which can exacerbate market swings.

The Federal Reserve is tightening monetary policy for the world's primary reserve currency, which is slowly draining liquidity from global markets (as covered more in detail in our commentary From Quantitative Easing to Quantitative Tightening and Preparing for Late Credit Cycle Dynamics). We should expect to see more of these short sharp markets sell-offs as the Federal Reserve and other major central banks withdraw stimulus.

At the time of this writing, global equity markets have calmed at the end of what has been a turbulent week for global stocks. Following the most recent sell-offs, equities have managed to recover somewhat, but we would not be surprised if these quick instances of volatility were to persist.

At this point, we do not believe there are any urgent actions for investors to take. In our forthcoming Global Dynamic Asset Allocation report for the fourth quarter of 2018, we do suggest modestly reducing exposure to risk assets by underweighting corporate credit securities, where spreads, we feel, leave little upside potential. Nevertheless, we suggest maintaining a neutral allocation to equities. We do not see this as the start of a bear market since macro conditions remain solid. However, we also do not view this as a buying opportunity for developed market equities (apart from rebalancing) either, as valuations, particularly in the US, remain elevated and could come under pressure from higher rates and risks to the outlook remain (particularly with regard to trade). We expect that this evolution will create higher volatility over the next few years, and investors should expect sharp drops from time to time. We will also be looking for opportunities to take advantage of larger dislocations, if movements become more substantial.

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FOOTNOTES

[1] *S&P 500 Composite Index, total return in USD. Source: Thompson Reuters Data Stream and Mercer Analysis for this index and all indices mentioned below.*
[2] *MSCI All World ex USA and MSCI Emerging Market Indices, both total return in USD.*
[3] *CBOE Volatility VIX Index.*
[4] *NASDAQ Index, price return in USD.*
[5] *ICE BofAML US Treasury Current 10 Year Redemption Yield*

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