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Chief Investment Office Americas, Wealth Management

From overdue to overdone?

What happened?

After 19 months without so much as a 5% correction, the S&P 500 fell by another 4.1% on Monday, bringing its six-day cumulative decline to 7.8%. Market volatility surged, with the VIX rising by more than 100% from 17 to 37. The yield on the 10-year Treasury bond dropped 14 basis points to 2.71%, reversing its rising trend year-to-date. But broadly speaking, US sector performance did not behave in a classic "risk-off" manner. While defensive sectors such as utilities and real estate were the top relative performers, healthcare and telecom both fell by more than the 4.1% market decline.

What triggered it?

Unlike last Friday's 2.1% sell-off, which was likely sparked by inflationary fears when US average hourly earnings jumped to a post-crisis high of 2.9%, there were no obvious economic triggers to today's market decline. Technical factors likely played the lead role in the continuation of selling pressure and the speed of the late-day decline. Both the deleveraging of select institutional buyers with portfolio risk limits, and the market breaching its 50-day moving average, likely accelerated the intra-day drop.

What are the key takeaways?

While the speed of the market declines over the past week is jarring, market declines of this overall magnitude are not uncommon. Over the past 40 years, US stocks have averaged a 10.6% peak-to-trough intra-year decline during bull markets. And the positive fundamental backdrop of above-trend global growth and healthy corporate earnings remains intact. Indeed, amid the day's sell-off, the US ISM non-manufacturing index rose to a stronger-than-expected 59.9 and the new-orders and employment components also rose, suggesting underlying growth momentum remains strong. Elsewhere, Japan's services PMI rose to a three-month high, and China's service sector PMI hit the highest level in six years.

In our view, risks of the Federal Reserve raising interest rates too quickly and triggering a US recession over the next two years appear very low. Meanwhile, the median S&P 500 return in non-recessionary years since 1960 has been 15%. Further, following past spikes in volatility (VIX above its 90th percentile), the S&P 500 has posted 12-month gains 87% of the time, with a median return of 22%.

That said, markets are likely to remain volatile in the near term. A single-day decline as sharp as Monday's could force further selling as some systematic strategies are forced into deleveraging, and other investors face margin calls, before longer-term investors such as pension funds begin to rebalance and buy the dip.

For private investors, portfolio diversification is always paramount. The rally in Treasury bonds reinforces the case for diversification, and holding assets uncorrelated to stocks. Investors should consider rebalancing strategies if their portfolio allocations have drifted away from their target ranges. While volatility may persist in the very near term, we remain confident that the bull market remains intact. We may have moved from being "overdue" for a pullback, to approaching "overdone," with this latest technical-driven sell-off.

Should you have any comments or questions, please email ubs-cio-wm@ubs.com.

Best,
Mark Haefele

Appendix

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