Lynx Investment Advisory

The Recent Sell-off and Prognosis

The stock market's recent sell-off is a good reminder that markets don't go up in a straight line. The S&P 500 Index is back to its mid-November 2017 levels, giving up its gains for the last 3 months. The recent sell-off accompanied by heightened volatility has left many wondering about the cause and prognosis. While we at Lynx cannot predict the movement of the market, we will discuss the cause of the recent sell-off and the outlook for the markets.

In our opinion, all corrections need three things: one, a ripe environment driven by rich valuation or outrageously positive momentum; two, a trigger, which is generally an event or series of events that acts as a catalyst for the sell-off, and finally, a crowded trade, the bursting of which perpetuates the volatility. The current sell-off exhibited these three conditions. The bond market had already suffered a sharp rise in yields in January while the equity market continued its rise driven by excessive momentum, which gained over 6%. While many have ascribed the initial sell-off to the wage inflation number of 2.9% that came out on Friday, Feb 2, we at Lynx are not convinced. If we were to believe that the market was concerned about inflation then we would have seen a jump in the 'break-even rate' which didn't happen. The break-even rate is a measure of expected inflation and is the difference between the yield of a nominal bond and an inflation linked bond of the same maturity. In our opinion, it is not a coincidence that the infamous Republican Memo was released on the same day as the sell-off. We believe that, in conjunction with this memo, the uncertainties associated with the new Fed chief triggered the selling. The accelerator was the short volatility trade that many investors had been piling into, which was a bet that volatility, at a record low at the time, would continue to decline. Please see Chart 1 showing XIV, an exchange traded note (ETN), now defunct, that offered investors the inverse of the daily performance of the S&P 500 VIX Short-Term Futures index, and attracted unusually high money flow recently.

Chart 1 (top XIV price/bottom XIV fund flows)

Source: NedDavis Research

XIV had dramatically outperformed the market until recently with over 1200% return since its inception in late 2010, while in contrast, the market had only doubled during the time frame. In afterhours trading on Feb 2, the music stopped as sophisticated investors (hedge funds/speculators) sold futures contracts representing a bet that the volatility would increase, which sparked violent selling by others in the market the following Monday morning as it became clear that volatility was on a violent swing to the upside (VIX spiked). Investors scrambled to try to understand the market turmoil while the fund providers attempted to meet margin calls demanded by the futures market. The story ended on Feb 9 with XIV losing 95% of its value (see Chart 2), forcing Credit Suisse (the issuer of the XIV of the ETN) to redeem investors and stop offering the notorious ETN. (Please see the below footnote for a more technical explanation of the market activity).

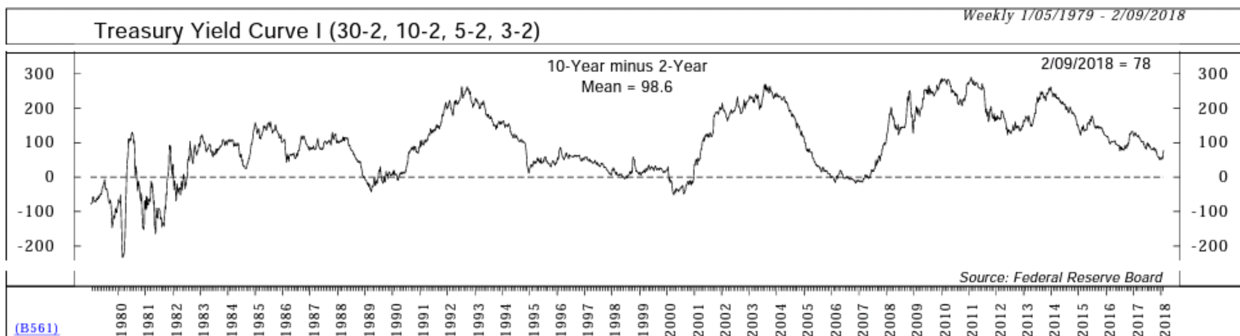
Chart 2 - XIV ETN Price Chart

Source: Yan

At Lynx we have been advising caution due to valuation concerns and that hasn't changed. It is likely that the equity trading will remain choppy but we don't see a bear market (technically a 20% correction), developing given that the global economy is firing on all cylinders. So far 80% of the companies have released their earnings and the average revenue has increased by 8.5% and net earnings are up by 13.5% year over year. The healthy earnings numbers are a reflection of a solid economy. Having said that, much depends on bond yields. The bull-market has been driven by highly accommodative monetary policy, and while fiscal stimulus in the form of tax-cuts can provide the tailwind, any sharp rise in bond yields as we saw in January will lead to repricing of equity markets. Also, for the last few years, we have argued that stocks are cheaper than bonds and relatively a better investment. This too will change

as bond yields rise; money will likely move from stocks to bonds. Currently we are focused on the relatively flat yield curve, or the difference between the 10 year and 2 year treasury yield, which is a mere 78 basis points (see Chart 3). This will likely lead to a few scenarios; a recession if the yield curve becomes inverted, a sharp correction in long-term rates where 10 year yields cross 3% or, best case scenario, a slow correction. Any sharp correction in long-term rates will not be beneficial for long-term bonds or stocks. The ideal scenario is for a slow correction in long-term rates and a continuation of an accommodative approach by the Fed.

Chart 3



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Your team at Lynx will be on the lookout for opportunities that this heightened volatility and dislocation in prices may create but in the meanwhile, please let us know of your concerns and questions, as we always look forward to hearing from you. Thank you for your trust.

More Detail Behind the XIV Trade:

As mentioned above, XIV's extraordinary performance was based on the subdued volatility, as well as the fact that VIX futures had been in contango for years as the equity markets remained in relative calm. When a futures market is in contango, distant futures VIX contracts are more expensive than near-term futures contracts. Therefore, when VIX contracts expire and roll over, the contract holder must sell the expiring futures contract at a low price and buy a distant futures contract at a high price, which creates a negative roll yield. The difference between the expiring and distant futures contract had been approximately 5% over this period of low volatility. XIV which offered inverse performance of short-term VIX gained from this roll yield, generating a 1200% return since inception. When volatility surged, the fund providers of products like XIV were forced to buy puts, or sell equities to cover their risk and margin.