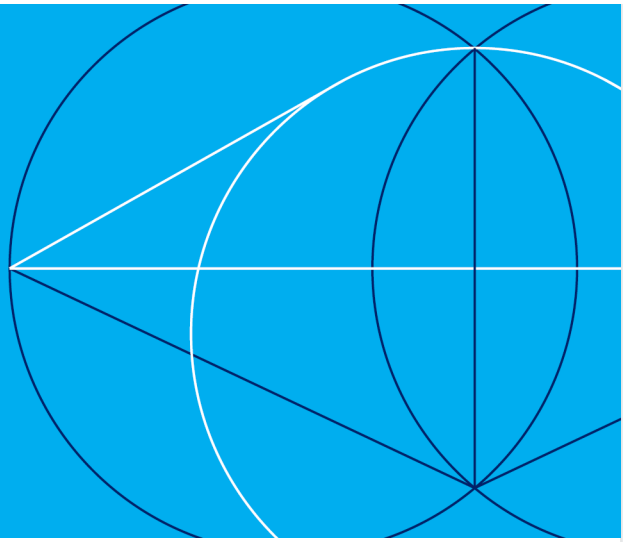
AQR

Macro Wrap-Up



High Volatility Q&A

February 16 2018 — We've gotten a lot of questions on last week's Wrap-Up and more generally on the recent volatility. Many of them were about analogies to past bear markets in stocks. Surprisingly, all of the questions were civil. We'll answer some of them here.

Was last Monday's S&P 500 drop the worst one-day move in the history of the world?

It wasn't. It looked like it was in nominal terms, but that is only because the S&P 500 was at such a high level. As a percentage move, it was only the 25th worst move in the past 10 years. Calling it the worst one-day drop is like saying Brett Favre is the worst quarterback in history because he threw the most interceptions. He just played a lot of games. In reality, he probably wasn't even the worst Jets QB. If you're looking for a record move, the VIX Index did have its biggest single day move last Monday, but data on that index only goes back to 1990.

Aaaaaaaaaaaaaaaaaaaaaaaaaaaaaaaaaaaaaaaahh!!

That's not a question, but one of the more frequent comments we've been hearing.

Is this like 2008?

Not at all. There are very few similarities. In 2008 we had seen the bursting of the housing bubble, a slowing economy, oil at well over $100, the Fed Funds rate at 4.25% and some serious credit issues at major banks. None of those conditions exist now.

How about mid-2000?

You mean the end of the tech bubble? No. We aren't seeing high real rates or an aggressive Fed. More importantly, we don't appear to be headed into a recession. By traditional value measures, prices aren't as stretched as they were back then either, but that's not a high bar.

You are being very negative on negative analogies. How about 1987?

There are some similarities, but also some important differences. In 1987, we had a new Fed Chair who was raising rates, a weak dollar and some trade conflict. That does sound familiar. But before you panic, remember that there were more signs of economic weakness back then. We haven't seen the stretch of bad news that came in September and October of 1987. The 1987 crash is widely believed to have been caused by problems in market structure. A lot of folks have talked about structural issues with the current market, but from what we can tell they are exaggerated and far from what existed in 1987.

Okay fine, so it wasn't like three of the most famous recent market sell-offs. Do YOU have any better examples?

No analogy is perfect, but two seem apt. The October 1997 mini-crash came during a strong economy while the Fed had hiked its key policy rate earlier in the year and was expected to move slowly going forward. The mini-crash may have been exacerbated by a hedge fund that blew up, partially because of a short position in options. One difference between 1997 and now is that emerging markets were on the edge of a crisis in 1997. Emerging markets have held up very well this time. Another analogy could be August 2015, when the S&P 500 fell 11.2% in a span of six days. That was likely caused by China's decision to more freely float the renminbi and fears about a China meltdown. Those fears ebbed fairly quickly.

Why are credit markets not reacting like equity markets?

Credit spreads have widened, but not to the extent you might expect given the sharp move in equities. The move has been remarkably contained. This is reassuring in that it indicates the equity move is more likely technical in nature and not part of a significant regime change in which you would see a broader set of market moves. However, credit is capable of non-linear moves. It can be slow to react, but then suddenly move aggressively.

Last week's Wrap-Up argued that a higher wage number was the catalyst for the move in stocks. A lot of writers are skeptical and have proposed alternate causes. Why is that?

Some argue that the average hourly earnings number is not a great measure so it shouldn't move markets. Some argue that inflation was already evident before the number came out. Others argue that inflation is still well contained. The reason so many people are skeptical may be that inflation is an obvious straightforward cause. It sounds more insightful to find something else, but that doesn't make it any more accurate.

What about all of the volatility in exchange traded products (ETPs)? Didn't they move markets?

Their rebalancing flows, which were likely concentrated at the end of an already volatile day, may well have. If you read a lot of financial commentary it's easy to think that fundamentals

magically drive markets, but of course the mechanism is through people buying and selling. Having technical players participating in a market move doesn't mean that there wasn't an initial fundamental cause. ETP rebalancing flows may have been part of an overreaction to that fundamental cause and perhaps the reason the VIX jumped so much. Some folks have discussed the effects of other strategies on markets, but we are skeptical.

On Wednesday, the inflation number was above economists' expectations. After an initial sell-off, the stock market rallied and closed higher. What happened there?

It is evidence that markets may have overreacted to one fundamental story (inflation) and are now returning to other themes (growth). Some folks will say that some rising inflation is already priced-in, whatever that means.

You have emphasized contrasts with the famous bear markets of the past, but what should investors be concerned about? What would make the current environment more similar to those times?

The biggest risk in the medium term is still inflation and an aggressive response by the Fed. If real rates reach levels that they have during those episodes in the past, it could present problems for the economy. We're not there yet. Signs of deterioration in credit would also be a big warning. One thing to remember is that monetary policy tightening and slowing growth can affect markets with a lag. This may give investors time to react, but it can also breed complacency as markets seem to ignore weak fundamentals. With that said, if there is one lesson of the past two weeks, it is: don't overreact to a single data point.

Will anyone remember this move in a few years?

It's just like the volatility spike in the summer of 2011, which everyone remembers like it was yesterday. Okay, probably not.

What We Are Watching

U.S. FOMC Minutes (Wednesday)

A lot has happened since the January 31 FOMC meeting. Jay Powell officially stepped into his new role as the next Fed Chair, with Janet Yellen saying her farewells and giving a rare interview on PBS. January nonfarm payrolls, average hourly earnings and consumer price inflation data came in higher than expected. Global equity markets tumbled, although they have partially recovered. We heard a number of individual Fed members' views on recent market moves, with the general Fed view being summed up by New York Fed President William Dudley who said that the moves have been "small potatoes." As a reminder, the FOMC left its key policy rates unchanged at its January meeting and released a statement that suggested "further" rate hikes were likely. In addition to looking for hints around shifts in expected timing or pace of rate hikes, the minutes will be closely scrutinized to tease out the Fed's broader macro views. With the Tax Cuts and Job Acts officially passed in late December, the January meeting was the first meeting at which the Fed could firmly discuss its implications. With only the monetary policy statement released at the January meeting, the FOMC minutes will be read for clues to potential changes to the Fed's view due to the increased fiscal stimulus.

South Africa Budget Announcement (Wednesday)

One of the meaningful risk events for South Africa was recently resolved. On February 15, Cyril Ramaphosa was officially sworn in as the new President of South Africa. This followed a back and forth struggle within the African National Congress party to convince former President Jacob Zuma to step down after numerous state capture and corruption allegations. Although one risk event has passed, another quickly arises. After last October's mid-term budget statement showed a worrisome widening in South Africa's forecasted budget deficit, S&P downgraded South Africa's local currency debt to below investment grade. This left Moody's the sole rating agency of the big three (S&P, Fitch and Moody's) with its rating for local currency debt above investment grade. Moody's has another rating decision in March and this week's budget announcement will likely play a meaningful role in determining the outcome. If the budget continues to show an unsustainable fiscal path, Moody's could cut South Africa's local debt to below investment grade, which would trigger the removal of South Africa from a large bond index. If Ramaphosa is able to work with the Finance Ministry to find a more sustainable fiscal path, confidence in investing in South Africa could continue to rise.

Eurozone Flash PMIs (Wednesday)

The Flash release of the Purchasing Managers Index for the eurozone gives one of the first looks at the economic performance of the monetary union over a given month. The eurozone has been growing at a healthy clip over the past year, benefiting from synchronized global growth, increased consumer confidence and increased business confidence. In January, the composite PMI rose to its highest level in over ten years. The Flash release for February will be watched to see if this positive economic momentum has continued into February. Given turmoil in equity markets at the beginning of the month, this report could provide an indication of any potential impact on business confidence, as the index is compiled from survey responses in the second half of a month.

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1 It was the 138th worst move looking at data going back to the beginning of 1928. (Source: Bloomberg)

2 Or saying Gianluigi Buffon is the worst goalkeeper in the world. Or that some cricketer is the worst because he played a long time and made a lot mistakes even though he was really good.

3 The VIX Index had its largest move since the data begins in 1990 in both notional and percentage terms. (Source: Bloomberg)

4 As of 2/15/18, the S&P 500 traded at a P/E of 21.9, using trailing 12m EPS. During the tech bubble, the S&P 500 traded at a high of 30.6. Using next years forecasted EPS, the S&P 500 traded at a PE of 15.8 as of 2/15/18 versus a high of 24.8 during the tech bubble. (Source: Bloomberg)

5 Washington Post: "Market's Crash Destroys Trader," 11/17/97

6 Bloomberg

7 While the S&P 500 sold off 8.5% from 2/2/18 to 2/8/18, BBB corporate bond spreads to U.S. Treasuries only moved 2bps wider, from 1.21% to a wide of 1.23% over the same dates. This remained near the tightest levels seen over the past decade. (Source: Bloomberg)

8 January CPI ex food and energy rose 0.3% MoM versus the Bloomberg median survey estimate of 0.2%. (Sources: Bloomberg, Bureau of Labor Statistics)

9 "S&P downgrades South Africa's local currency debt to 'junk' status," 11/24/17