Market Update: Sell-Off Overlooks Solid Long-Term Trends

February 6, 2018

Key Takeaways

- The current equity sell-off has been triggered by fears of higher inflation and higher interest rates that have been exacerbated by investor complacency.
- We believe the selling is overdone and that the market can handle higher rates if the ascent is not too rapid.
- Long-term volatility measures suggest investors are willing to look past short-term price swings and focus on solid economic growth as a driver of equity performance.

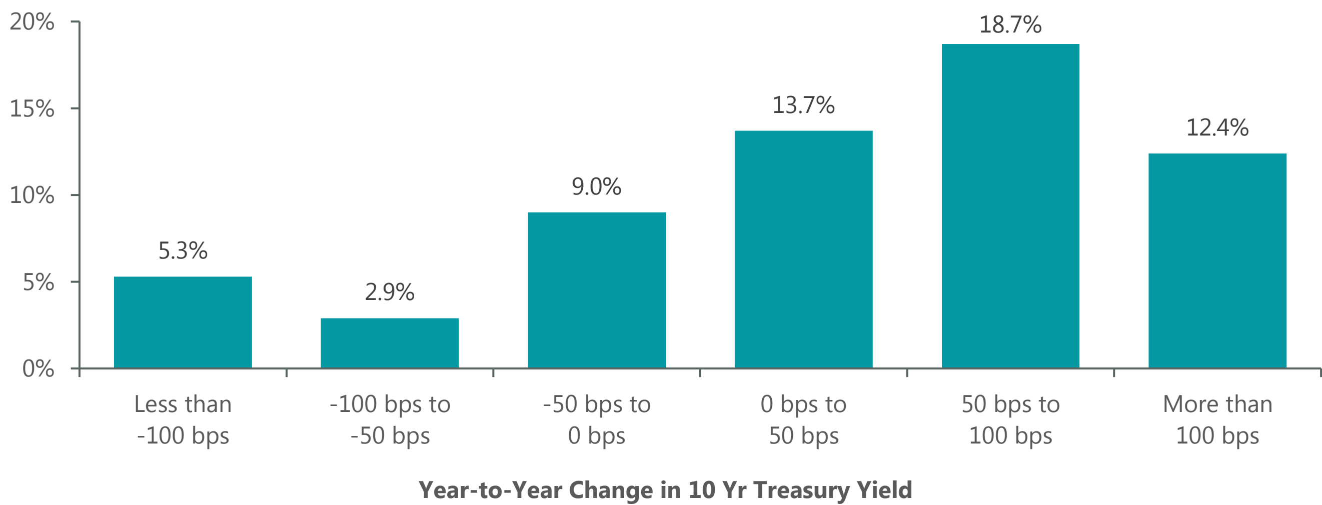
Treasury yields have been steadily rising since September and until late January, equity markets had been digesting this move with little trouble. However, a spike in interest rate volatility over the last two weeks, exacerbated by strong wage inflation data from the January jobs report, has led to the largest equity sell-off in two years. Average hourly earnings came in at 2.9%, the highest level since 2009, causing some to question if inflationary pressures are about to rise, and whether the Fed may be behind the curve.

In our view, the market has overreacted to these events. We believe the real culprit behind the recent sell-off has been investor complacency. Prior to last week, the market had not seen consecutive daily declines for 310 days. Further, the record streak of days without a 5% correction was only broken yesterday. These types of streaks are rare and are typically followed by heightened volatility as fear begins to percolate back into investor minds.

To put it in perspective how content investors had been acting, it's best to look at sentiment surveys like the Investor Intelligence Bull/Bear Ratio. Last week, this measured 5.24, its second highest reading of all time. With complacency the real driver behind the equity sell-off, we believe the market can handle somewhat higher rates in the coming months as long as the ascent is not too rapid.

Our 2018 outlook highlighted rising interest-rate and equity volatility as key themes. We felt that interest rates would rise for several reasons, including a doubling in Treasury issuance from 2017, rising inflationary pressures, stronger economic growth (with a tailwind from tax reform) and a wind-down of the ECB's QE program. Since bottoming in early September, 10-year U.S. Treasury yields have risen 80 basis points. Despite rising interest rates, the S&P 500 has risen 18.7% on average during the previous periods since 1990 when Treasury yields have increased between 50 and 100 bps (Exhibit 1).

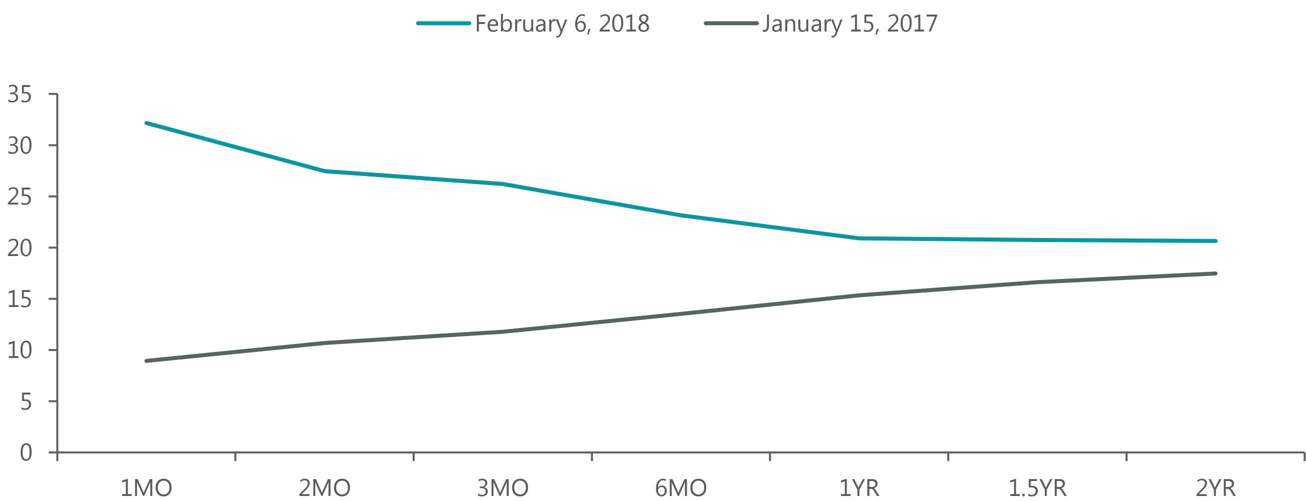
Exhibit 1: Stocks Can Withstand Higher Interest Rates (S&P 500 Average Rolling 1-Year Performance Based on Treasury Yield Change)



Monthly data from Jan. 1, 1990 through Jan. 31, 2018.Source: BMO Capital Markets, Bloomberg, Federal Reserve Board.

While volatility has spiked, with the VIX rising to its highest levels since 2011, it is important to distinguish between short-term and long-term volatility. While the VIX has surged, derivative contracts for longer-term volatility have seen a much more muted move (Exhibit 2). This tells us investors are willing to look past the short-term market action and expect volatility to fall from current levels as the market re-focuses on stronger economic growth in the U.S. and abroad.

Exhibit 2: Long vs Short-Term Volatility



Source: Bloomberg.

About the Author

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