BLACKROCK INVESTMENT INSTITUTE

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The stock swoon in context

Key views

- We see the stock swoon as contained and driven by an unwinding of popular trades betting on low equity volatility.
- Our conviction on the upbeat and steady economic outlook suggests the equity pullback is an opportunity to add to risk assets such as EM stocks.
- A market regime change would require a deterioration in the economy and be accompanied by an increase in macro vol.

Global equity markets suffered a sharp reversal in early February after notching a string of record highs. We believe the slide is mainly driven by an unwinding of popular trades betting on low equity volatility. The near-term outlook is highly uncertain, as sentiment shifts can stoke large market swings. Yet we believe investors should take the long view. Our conviction on the upbeat and steady economic outlook suggests the equity pullback is an opportunity to add risk to portfolios.

Leveraged investment products tied to low volatility magnified a downdraft that appeared to stem from investor jitters over the stock market run-up, record equity inflows and rapidly increasing interest rates. These products bet on the VIX, the U.S. equity volatility gauge, falling or staying low. We believe the early February swoon is mostly isolated to equities. The sharp volatility spike has not spread to other assets such as credit or foreign exchange.

BlackRock has long said well-structured exchange traded products are beneficial to both investors and securities markets – but has raised concerns about inverse and leveraged products. These are notes and commodity pools designed to move opposite or in a multiple of daily index returns. They are not liquid and, under stress, do not perform like plain-vanilla exchange traded funds tied to physical securities. They lack essential elements of valuation clarity and access, and often are not backed by a portfolio of transparent assets. This is why BlackRock does not offer them.

Periodic outbreaks of higher volatility can happen even within low-volatility market regimes. The sustainability of such a regime does not necessarily imply markets will return to the unusually low volatility levels seen in 2017. A market regime change would typically require a deterioration in the economy and be accompanied by rising macro volatility. We find that equity pull-backs are shorter and recoveries quicker during low macro volatility regimes. That typically makes them buying opportunities.

We see the synchronized global expansion carrying on in 2018. Our BlackRock Growth GPS for G7 economies is holding at its highest levels in three years, with consensus expectations catching up as the expected boost from U.S. fiscal stimulus gets baked into forecasts. Upbeat data are coming in around the world, most recently from China and the eurozone.

The U.S. expansion is on course to become the longest on record, stirring concerns it is about to run out of steam. But is it? The recently enacted tax overhaul and higher federal spending could add 0.8 percentage point to U.S. GDP growth in 2018, we estimate. This could tip the balance toward accelerating growth. Such a boost could shorten the cycle's expiration date to two or three years. If overheating pressures are contained, the expansion may last longer. We believe this makes for a solid foundation to put money to work in equities, particularly in emerging markets.

Last week, markets appeared to wake up suddenly to one of our core themes for 2018: a modest inflation comeback in the U.S. Strong U.S. jobs and wage data on Friday helped propel 10-year Treasury yields to four-year highs. We see yields rising modestly from here and prefer (repriced) equities over fixed income. Equities are also supported by solid earnings momentum around the world. The market unrest is a reminder that the pace of interest rate increases matters.

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