RATHBONES

Weekly Digest

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The Huangover

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Economics, politics, and corporate news partly explain last week's sharp fall in US stocks – but there were also technical factors that have little to do with the real worth of companies.

Quick take:

- It pays investors to dig into the reasons for the large stock market slides sustained over a whole week, such as last week's drop.
- Indiscriminate selling driven by technical factors can provide opportunities, as babies are thrown out with the bathwater.
- To help explain what happened last week, we discuss how volatility works in stock markets.

Last week was momentous – for all the wrong reasons.

There have been only four times since 2010 when US equities have fallen for seven or more consecutive trading sessions (with only one example of eight times). Friday marked only the sixth time, since the US S&P 500 Index was launched back in 1957, when it fell all five days of a trading week, with at least four drops of 1% or more.

The previous examples are potentially instructive because they suggest the sort of background environment that the market might be trying to discount. They happened:

- Once during the Global Financial Crisis
- In 2001, the week after 9/11 (which was also in the midst of the dotcom bust)
- Twice during the notoriously inflationary and geopolitically volatile 1970s
- Once in 1962, following the imposition of price caps on steel producers by US President John F Kennedy, which inflamed existing fears about future profits generally across the market

Last week also saw the sixth fastest 10% correction – traderspeak for a 10% fall – for the S&P 500 since 1928. Notably, four

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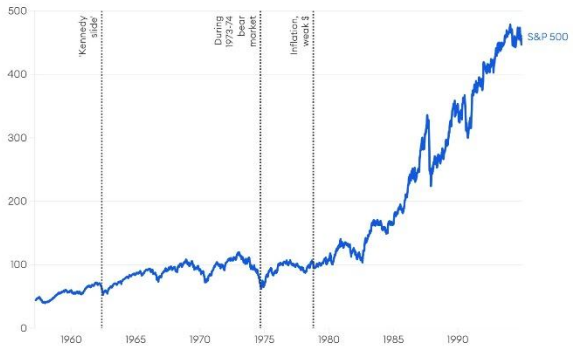
of the fifteen fastest have occurred in the last six years. This supports my belief that the current market structure and nature of the participants encourages such air pockets.

But market falls like this – and the structure of the market itself – can also send share prices rocketing afterwards. The announcement of Jensen Huang's return as Nvidia CEO pushed the S&P 500 up 4.7% on Monday, with Nvidia's market capitalisation increasing by an unheard-of $950bn on the day. Can one man be worth so much?

Maybe. But there were other forces at work. It's important for investors to understand the market environment in which they're operating because it might lower the likelihood of mistakes.

In its first 37 years, the S&P 500 fell all 5 trading days of a week - and by 1% on 4 of them - only 3 times...



Source: FactSet, Rathbones

...and since 2000 only 3 times



Source: FactSet, Rathbones

Liquidity overwhelms 'fundamentals'

There's plenty of evidence that much of the recent selling was undertaken not through choice but through force.

Let's start with volatility itself. This is the degree to which share prices or indices move around. It's most widely referred to in the form of the Vix Index (often called the 'fear index'), which uses the price of options to infer expected daily movements (implied volatility) of the S&P 500 Index. The higher the Vix, the higher the implied volatility: expectations among investors that the S&P is likely to move around a lot. A high Vix usually signals falling markets, but not always. When a higher Vix is associated with rising markets, it tends to

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signal unsustainable speculative behaviour.

Many fund managers decide their level of market exposure with reference to the level of the Vix (or other measures of volatility). Hedge funds, especially, will have more (borrowed) money working in markets when volatility is subdued because the risk of losing money seems lower. When volatility rises, chips have to come off the table. But there's a twist. Hedge funds balance their overall exposure to the market by selling shares they don't own in unfavoured companies or sectors (known as 'going short'). If they decide, instead, to sell their favourites (the 'longs'), hedge funds quickly have to buy back the shorts, boosting their share prices. At this point laggards can suddenly become leaders. Such rotation is becoming increasingly familiar, though it doesn't necessarily reflect strong fundamental demand.

Hedge funds and any other traders who use borrowed funds are potentially subject to the dreaded 'margin call'. When the loan is made, a certain amount of collateral has to be deposited with the lender to cover potential losses if the trade goes the wrong way. Let's say a hedge fund is asked to deposit 20% of the value of its loan in the form of a safe government bond. It can then borrow five times that amount to increase market exposure. But if the value of its investments falls, it will be asked either to reduce the exposure (which entails selling) or to provide more margin (which might entail selling something else to raise the cash).

In more extreme cases, if the hedge fund doesn't stump up more cash, the bank providing the loan will exercise its right to sell the underlying security to protect its own finances. This can trigger a death spiral of forced selling until either the hedge fund has nothing left to sell or the publicly quoted value of the stocks has fallen far enough that other investors find sufficient value to buy them. This summer's tech selloff was one such example, making hedge fund manager Leopold Aschenbrenner of Situational Awareness a household name after his fund had to offload 80% of its portfolio to fellow hedge fund Citadel.

Technically driven selling – as opposed to selling based on a change in how much investors think shares are fundamentally worth, after analysing the business – emanated from at least three other sources last week. More speculative retail investors have been attracted to 'leveraged ETFs' (exchange-traded funds). They work on the same principle as the hedge funds but are, if anything, even more sensitive to market movements. If the underlying security is going up, they have to buy more of it every day to retain the promised leverage: how much they've

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souped up returns by borrowing more to buy more. If the value of the underlying security is falling, leveraged ETFs must sell at the end of every day. This tends to exaggerate moves in the price of a stock in both directions.

There are also funds that buy and sell investments based purely on their momentum. Going up? Buy more! Going down? Sell! Going down even further? Sell something that you don't own (going short again).

Perhaps the most geeky of the lot is the 'gamma hedge' undertaken by options traders, which kicked in hard last Friday. For now, let's just say it's another case of one (very big) market participant looking to protect itself from losses. I hope that leaves you wanting to know more. I'll write more in an article in December's Monthly Insights publication. And we'll also look into the phenomenon of 'pod shops' – nothing to do with (actual) whales.

Why?

Of course, forced selling requires a catalyst. In retrospect, one can see four that, singly, might have been surmountable, but, collectively, obviously were not:

- A shift in policy emphasis from the US Federal Reserve (towards more hawkish) at October's rate-setting meeting
- The Democrats' resounding victory in the mid-terms – we wrote an investment take on this, on the day, and an analysis ahead of the results that stands up well
- The Nvidia affair (in both senses of the word – and, complicating corporate governance at Nvidia, strictly speaking the Nvidia affairs)
- The Anthropic initial public offering, making it a public company

All of this has shifted investors' investment horizons. A few months ago, seemingly bullet-proof near-term earnings projections for any company involved in AI encouraged investors to take on trust growth estimates that extended to 2029 and beyond. Now they're demanding more evidence. And when one's trying to estimate variables such as revenue, profitability, and the cost of capital half a decade away to determine the value of shares today, the range of valuations is unfeasibly wide. Investors are therefore demanding a higher risk premium even for companies that appear extremely profitable today. But this can provide opportunities as babies are thrown out with the bathwater.

Again, I intend to dig more deeply into all of this in next week's Monthly Digest, by when I hope some more dust will have settled. But I'm not ruling anything out. As I observed to a colleague now in his

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seventies, it doesn't matter how long you have been in this game; you can never say you've seen it all!

Meanwhile, I'll leave you with a comment by our Chief Investment Officer Robert Sears, this week, which explains the right mindset at times like these: "The right response is neither complacency nor capitulation – selling out of the market – but disciplined judgement, careful monitoring, and a willingness to act as the evidence changes."

You can read more on Robert's views here.

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Regional highlights

UK. Purchasing manager surveys offer timely insights into the state of the economy. S&P Global's Manufacturing index for the UK fell from 52.8 to 52.7 in November, with Services falling from 52.8 to 52.0. The press release cited "cost-of-living pressures" and "subdued demand in the real estate sector, alongside general headwinds from geopolitical tensions". The Composite Index, which includes all sectors, fell from 52.9 to 52.3. All are still comfortably above the 50 mark that demarcates economic growth from contraction but the best may be behind us. The more granular manufacturing output balance rose from 53.6 to a 27-month high of 54.2, reportedly due to "a boost to sales from AI data centre build-outs" and "higher defence spending". But there is pain for consumers on the horizon, with energy regulator Ofgem confirming that the household energy price cap will rise 26% in January. This would take a typical annual utility bill up from £1,723 to £2,166, on current energy prices. If we add the high cost of refinancing the very popular 5-year fixed rate mortgages taken out in 2021, that's a strong headwind for many consumers next year. We believe this will prevent the Bank of England from raising interest rates too aggressively.

US. S&P Global's purchasing manager index (PMI) readings for November showed a small slowing of economic momentum but nothing to cause immediate concern. If anything, healthy growth but not so strong as to surge above trend is the 'Goldilocks' environment that investors and central bankers should welcome. The Manufacturing reading slipped from 54.9 to 54.5, with Services down from 56.1 to 54.7, leaving the Composite measure at 54.6 (from 55.9). All are still well above the 50 mark. The report also highlighted modestly softening price pressures, following the sharp increases in the manufacturing input and output price components in October, which is a bonus given lingering inflation pressures. A more positive surprise came from the Conference Board's Consumer Confidence indicator, which leapt from 91.9 to 103, the highest level since February (and since the start of the Iran War). Unsurprisingly, Democrats (and Independents) were more upbeat than Republicans after the mid-term election results.

Europe. November PMIs showed eurozone activity holding in expansionary territory halfway through Q4. Input cost pressures eased somewhat, but firms only passed on part of the relief in costs to selling prices.

At the composite level, eurozone PMI remained unchanged at 51.7, as a further improvement in manufacturing output (from 52.8 to 53.3) offset a slight softening

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in services (from 51.4 to 51.2). The headline manufacturing index, a weighted average of five sub-indices (output, new orders, employment, suppliers' delivery times, and stocks of purchases), edged up from 52.7 to 52.9, as gains in output and employment outweighed weaker new orders and a lower stock of purchases index. But the contrast between Germany and France is stark. Germany, buoyed by fiscal stimulus, saw the Composite measure rise from 53.4 to 55.0. France, mired in political turmoil and facing an unsustainably high-budget deficit, saw its Composite reading fall from 46.6 to 46.2.

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