

Late cycle features at play: more pain, but not the end of the game



Pascal BLANQUÉ
Group Chief
Investment Officer

- **Market sell-off: a late cycle feature where uncertainty due to tariffs, rates and oil prices are sending some red signals.** Autumn comes with a change of mood in the market triggered by rising US Treasury yields, amid a hawkish FED committed to avoid any sign of overheating, and uncertainty surrounding the upcoming earnings season. All elements that will keep volatility on the rise over the next weeks.
- **Not a scary movie, but be ready for more pain.** Yet, we see this as a market correction, rather than the start of a prolonged bear market. We expect some a further down trend also due to the technical reallocation of market risks. Growth areas of equity markets and high leveraged areas of the credit markets with tight valuations are the most vulnerable places at the moment.
- **How to face this environment:** add duration in US debt, stay diversified in terms of risks, focus on quality and liquidity in credit, go for value (use available liquidity to buy the most discounted names) and stay out of stretched growth areas.

What are the reasons behind equity market sell-off in the last few days?

Autumn is leading to a change of mood in the market, with volatility spiking (+100% change in the VIX in one week) to levels not seen since last March. The recent equity market sell-off has been quite strong with extreme one-day moves in major equity indexes across the board pointing to a start of a correction (MTD performance: S&P500 – 4.4%, Eurostoxx50 -5.2% and Hang Seng -9%). Part of the reason for this sudden change is due to the features of a late cycle phase when even positive news can be read as bad news for the markets. Record low unemployment in the US and a perceived more hawkish tone from the Fed had been pushing up US Treasury yields above 3.2%, the highest levels in the last 7 years. The release of Producer Price Index on Oct 10th with readings of core PPI at +2.5% suggests further upside in inflation leading to a continuation of FED tightening, with the risk of being more hawkish than expected. This rise in rates comes as we enter the last reporting season of the year (with US banks starting October 12th), with markets already more concerned about possible impact on earnings from the tariffs, emerging market exposure and oil prices trending higher. Stars are aligning for a possible market correction as market sentiment is weakening. The first reaction is a reallocation of risks out from the tech sector, with the NYSE FANG Index already down -10% MTD and -18% from this year highs.

What can we expect for the next days/weeks?

We expect further volatility and possible additional down moves. Some technical adjustments will occur in the coming weeks, possibly affecting not only equity markets but also high yield bonds. Systematic players, risk parity strategies and more generally investors with volatility limits may be forced to reduce their risk, amid rising volatility. The focus will be on the US earnings season, so any news will be carefully assessed by the market. We are coming at the points where multiple political actions will show their effects, such as tariffs on earnings outlook and inflation, sanctions on Iran, driving up oil prices.

Do you believe it is a buy opportunity or will this volatility last for a while? Is this the beginning of the end of the bull market?

This volatility may continue to year end, but a full reversion to a bear market trend is something different and in our view the **configuration that is opening in front of us has more to do with a correction, as the bear checklist is not yet flashing red.** Economic indicators are still sound with growth above potential albeit slowing also in the US, while on financial market indicators, the picture is more scattered but not scary. Liquidity and tightening conditions are somewhat deteriorating (spread widening, higher real rates), but without major areas of excess



Vincent MORTIER
Deputy Group Chief
Investment Officer

With the contribution of
Claudia Bertino,
Laura Fiorot
Investment Insights Unit

“We expect further volatility and possible additional down moves led by the growth part of the market and possible pressure on the high yield side as well. But it is not going to be a market capitulation.”

in the market. Leverage seems to be decreasing in the US, no excess in Europe, with some areas to watch in EM. There are no signs of excess IPOs, but some mounting activity in M&A in US, less so in Europe. Strong downward revision in earnings is also an element on the checklist and it is where markets will focus now.

Which strategies can investors put in place to deal with this correction?

We entered this market phase with a cautious approach, conscious that volatility may spike a late phase. In a late financial cycle, we prefer equity markets over credit and we are cautious on high yield segments. Amid rising volatility in risk assets, **adding duration** in the US can be a defensive strategy, while we still see little value in European core bond yields. We have recently become more constructive on duration in the US. As rates have risen, short and medium term Treasuries have become more attractive. In Europe, we keep a low duration stance, given the still low Bund level. Also a more neutral stance on European peripheral bonds is appropriate, especially on Italy in this uncertain phase of budget law definition, to limit the overall risk of bond portfolios. In general, as **Central Banks action will continue to diverge**, flexibility in the duration and curve management will be key. On the **credit side**, selection remains the name of the game with a **focus on quality and liquidity**, as valuations are really tight. We believe investors should prefer short maturities where there is still value. With a strong USD and higher US rates, **EM bonds remain under pressure** and we see limited room for material spread compression in the short term, after the rebound in September. With the attenuation of country-specific stories, amid economic and policy adjustments, the asset class **can offer attractive opportunities for income** and carry with a long term investment horizon, but volatility will remain quite elevated. On **equities**, short-term challenges call for **caution in particular on the growth side** of the market. A combination of quality investing at reasonable prices and compelling value stocks is the best way in our view to seek opportunities out of this volatile environment, with some possible rotation into more defensive sectors. On a regional basis, we recommend overall global diversification. We believe that investors should continue to be focused on diversifying risk, but at the same time, embrace an active and flexible approach to seek opportunities from current market rotations.

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Important Information

VIX is the CBOE Volatility Index. Diversification does not guarantee a profit or protect against a loss.

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