

# A MOMENT IN MARKETS – IS IT RISK-ON OR RISK-OFF?

Mobeen Tahir – Director, Research  
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It is both. Upon a first glance, market movements in anticipation of, and in reaction to, second quarter economic data have been puzzling. Here, we put the pieces together to make sense of it all focusing on US asset markets.

## The dreaded reality check

The US economy contracted by over 9% year-on-year in the second quarter of this year (figure below). Initial weekly jobless claims for the week ended July 24th were 1.43 million – an uptick from levels earlier in the month<sup>1</sup>. These figures serve as an unpleasant reminder about the scale of the economic damage from the ongoing pandemic. A rebound in Purchasing Managers Indices (PMI) in June and July provide a glimmer of hope. They point towards early signs of what might be a slow and protracted recovery.



Source: WisdomTree, Bloomberg. Quarterly data from Q2 2000 to Q2 2020 showing US GDP CURY Index which is US gross domestic product (GDP) nominal dollars year-on-year seasonally adjusted.

**Historical performance is not an indication of future performance and any investments may go down in value.**

The US Federal Reserve (Fed) maintained its dovish tone following its meetings earlier last week. Monetary accommodation has become such a key driver of markets that it has almost become an overt component of the Fed's manifesto. But, as long as inflation doesn't rise meaningfully from current levels, such dovishness seems not only justifiable, but perhaps inevitable. The fate of the economic recovery also rests on any further stimulus from the US government – something Congress is still wrestling over.

## Is it risk-on or risk-off?

When it comes to economic outcomes that have a direct impact on asset prices, markets either ‘price in’ the impact ex-ante, so as not to be surprised – or react when the event happens. In semi-efficient markets, we typically get a mix of ex-ante and ex-post price action. Collectively, this price behavior ought to give us clues as to whether the sentiment in markets is ‘risk-on’ or ‘risk-off’. To allow for any market inefficiency, and to fully capture the impact of second quarter economic data, we observe price movements in US markets over the month of July:

Asset Class	July Move	Signal
S&P 500 Index	+5.6%	Risk-on
Gold	+10.9%	Risk-off
VIX Index	-19.6%	Risk-on
US 10-year yield	-19.5%	Risk-off

Source: WisdomTree, Bloomberg. Move over July 2020 shown. Total return shown for S&P 500 Index. Spot price movement shown for gold. VIX Index refers to the CBOE Volatility Index (VIX).

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None of the above showed a surprise reaction to the second quarter GDP announcement and, generally, they continued along the trajectory they were already on in July. In theory, this means that asset markets had already priced in the economic contraction. But do the conflicting sentiment signals make sense?

### Reconciling the mixed signals

There are 3 important learning outcomes from the aforementioned price behavior of the market:

**1. A holistic view of markets is required:** To gauge market sentiment, investors should look across asset classes as if it were a diversified portfolio. When liquidity is high and interest rates are extremely low, capital needs to be deployed. Investors are therefore participating in the cyclical recovery by investing in risk assets but diversifying with safe-haven assets like gold and treasuries.

**2. Monetary support has lent robustness to equity markets:** US equities brushed aside the 9.5% year-on-year contraction in the economy. With US equity indices at or above their all-time highs, it is hard to argue that this was already priced in. If investors are managing their risks by employing diversity rather than reducing equity exposure, this gives equity markets resilience in the face of economic risks.

**3. There may be significant upside potential:** So far, earnings from tech-driven stocks have led the way and this is unlikely to be transitory. The pandemic has merely

accelerated certain thematic tech-driven shifts which were bound to happen anyway. Having said that, if a vaccine helps the world emerge from the pandemic, this could create a strong bullish scenario for all equities as depressed sectors too will recover. Those high-quality companies that survive the ongoing crisis will be the biggest winners at the end.

<sup>1</sup> Source: Bloomberg

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