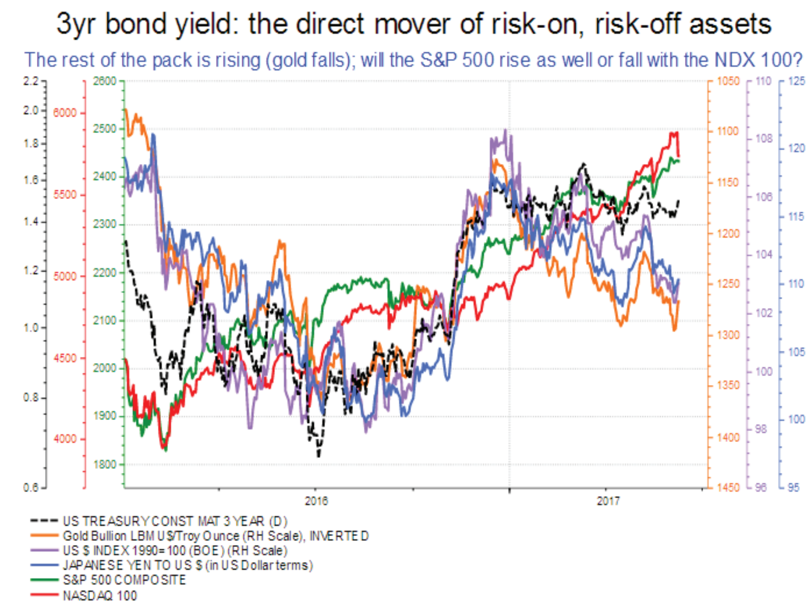
18 /Risk parity heaven or risk parity shock– which one will prevail, as S&P 500, the Dow, and Nasdaq 100 diverge

In recent weeks, both stocks and bonds had been rallying, which some analysts described as “risk parity” heaven – in essence, stocks and the bond assets they have been hedged with, were both making money. That ended after the advance publication of former FBI director James Comey`s summary of his encounter with President Donald Trump, who allegedly asked Mr. Comey to drop an ongoing investigation of former White House staffer Michael Flynn regarding unreported contacts with Russian authorities. Legal scholars determined that there was no “smoking gun” which could lead to Mr. Trump`s impeachment. Bond market safe haven trades were immediately reversed, leading to a sharp rally in bond yields, accompanied by a stronger US dollar and a weaker gold price. The reflex reaction of the S&P 500 index was to rise moderately as well, but inexplicably, the Nasdaq 100 subsequently fell sharply, as $100 bln of tech stocks got sold *(see graph on this page)*.

It gets stranger: volatility didn’t really move; there were no real flows, and there were no big options positioning, even as $100bln of tech stocks got sold, which drove the Nasdaq 100 down 4%, while the S&P 500 and Russell 2000 stayed unchanged and the Dow Jones hit a new high. The NDX 100 blood-letting was led by Nivida ($89bln market cap) which fell 15% on Friday from intraday high-to-low, that left the stock +4% on the week and +46% on the year. Some analysts speculated that moves like that seen in the NDX on Friday are not one-day phenomenon, and there could be follow-through selling.

Our analysis is sympathetic to those speculations in the very short-term but we do not believe that the NDX sell-off will go very far if the broad indices remain indifferent. And so far, the broader markets have been steady, or have even gained.

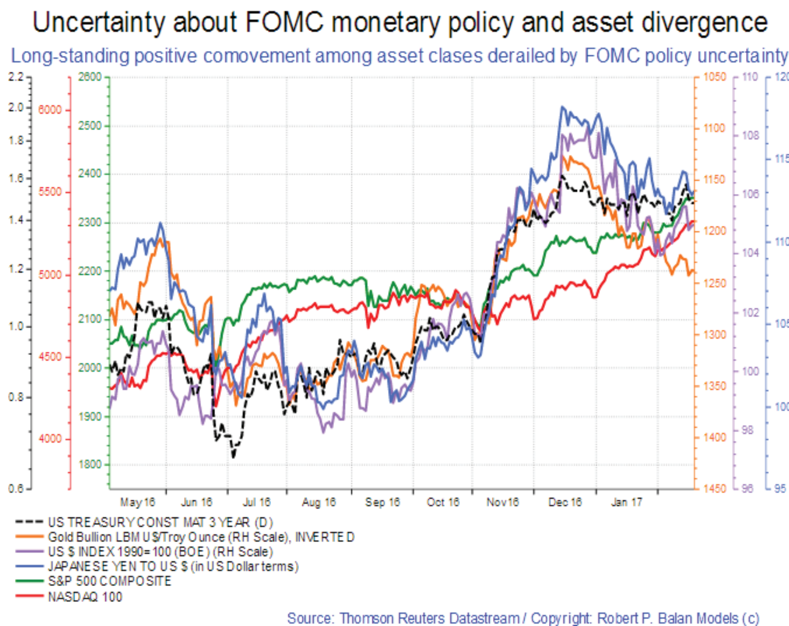


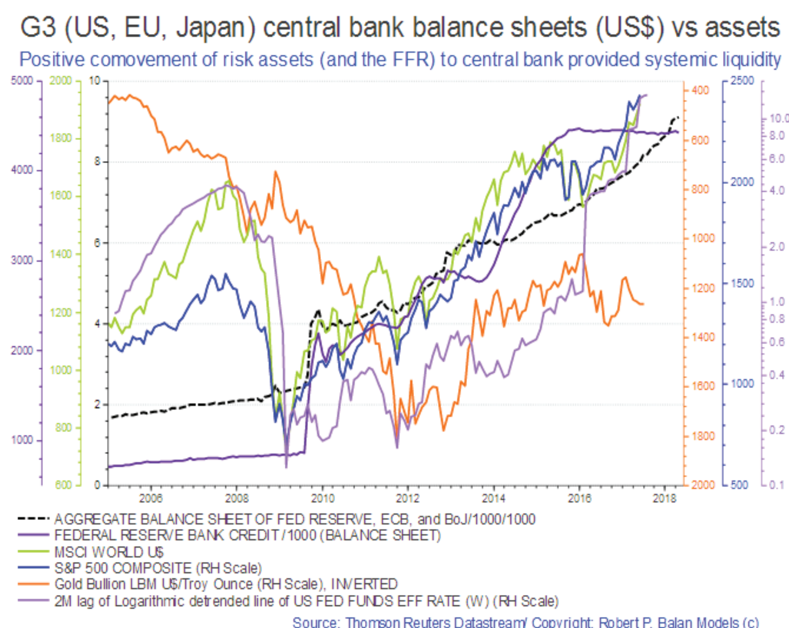
How the S&P 500 (and the rest of the broad indices) respond to the NDX sell-off is more than of academic interest of course. Some large investors have lately been suggesting that the equity markets are ripe for a significant correction. And the NDX 100 collapse does bolster those speculations. For those investors that have gone the way of the so-called “risk (premia) parity” trades, how the S&P 500 respond to the NDX 100 air pocket becomes exceedingly important. Risk parity investors were double winners when the S&P 500 was rising and US Treasury bonds yields were falling (bond prices were rising) – risk parity heaven, they called it. What the NDX 100 sell-off threatens is the other side of the coin – risk parity shock – when both investments in the asset allocation equation lose money as US equity markets fall even as bond yields rise. This would be opposite of the prevailing market situation up to about two week ago. Under this circumstance, both investments in equities and in its bond hedges will lose money.

Here is Wikepedia describing “risk (premia) parity: “The risk parity approach attempts to equalize risk by allocating funds to a wider range of categories such as stocks, government bonds, credit-related securities and inflation hedges (including real assets, commodities, real estate and inflation-protected bonds), while maximizing gains through financial leveraging.” The concept/process attempts to provide a lower risk and lower fee alternatives to the traditional portfolio allocation of 60% stocks and 40% bonds which carries 90% of its risk in the stock portion of the portfolio. The main thrust of the concept is to equalize the inherent risk on both sides of the allocation by applying leverage (usually via volatility plays) to the bond part of the portfolio in such a way that both stock and bond investments achieve true risk parity or equality in their risk profiles. The primary idea is to bump up the returns from the bond portfolio without unduly increasing the risk from this sector, or diminishing the yield potential from the equity part of the general portfolio.

It could also be that various investors in different parts of the market are shifting their focus to different points of time in the future, e.g., (1) Nasdaq investors looking ahead at Q3 2017; (2) Dow Jones Industrials investors are looking further forward in time to Q4 2017, and (3) while the broader indexes combine the better expectations for Q4 2017, which offset almost all of the more negative expectations associated with Q3 2017, insofar as the expected changes in the year-over-year growth rate of the S&P 500's dividends per share are concerned. This analysis is not far-fetched as investors showed similar divergent behavior towards the asset classes coming into Q1 2017, when there was extensive debate at that time whether the Fed would next raise interest rates within Q1 2017 or delay the next tightening episode to Q2 2017 *(see 1st graph on this page)*. One thing for sure – the schizophrenic behavior of the different stock indices and the various risk assets today are all tied down to the ramification of the June 14 FOMC meeting.

The implications of any forthcoming FOMC decision, whatever the time period is, has often derailed the comovement among risk assets, which started to manifest after the Fed and other developed economy central banks started implementing quantitative easing. Systemic liquidity from the central banks has been the primary driver of assets classes in a positive way, except in the case of gold. Curiously, asset prices also display positive comovement with the Fed Funds Rate, when it is lagged by two months. In practical terms then, the Fed's tightening bias since 2011 has paced the rise in asset prices (again, with the exception of gold), and has not been the negative factor that some analysts have made it to be on asset prices. It is the uncertainty about the next Fed policy which often times drives the temporary divergences, but after the policy tightening has been announced, risk assets usually go up together again, except for gold which falls *(see 2nd Graph right).*





Conclusion:

The divergences within the equity asset class, and among the general assets classes, have almost always been driven by uncertainty going into the next Fed monetary policy decision. So it had not been different over the past few weeks of schizophrenic asset class behavior, as the FOMC just met last week. The immediate response from the asset classes could vary, with the response from equities the biggest question mark. But based on historical performance since November 2008 (when systemic liquidity became the m ajor determinant of assets prices), after a clearing out of a few days, asset classes will likely resume the positive comovement that has defined their relationship post the GFC recovery. We expect the FFR and bond yields to rise, the US dollar to strengthen (and for gold to weaken), and the equity markets will probably resume their uptrend, in due time. It is the equity markets performance post-FOMC, which presents the biggest known unknown for us, this time around. We believe they will revert to the old positive comovement, post-FOMC, but we could well be very wrong on expecting that the relationship will persist. Caveat emptor on equities.