ITERAM

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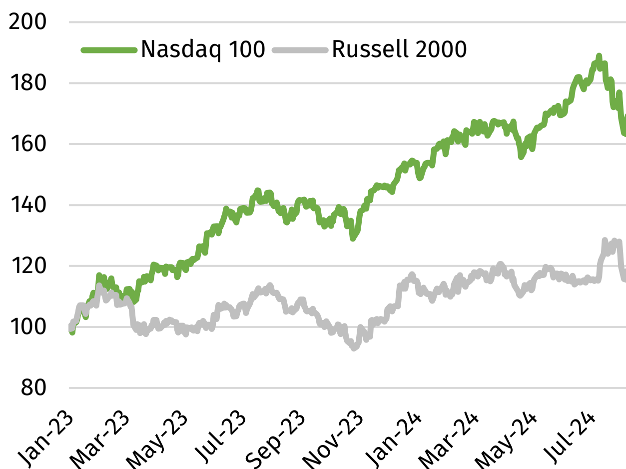
SUMMER OF VOL: THE PARTIAL UNWINDING OF MAJOR CROWDED TRADES

As the end of 2022, market participants were widely anticipating a global recession while simultaneously being worried about ramping inflation breaking a 40-year record at the time. Somehow unexpectedly, risk assets rallied in January 2023 and prices have been trading upwards ever since, as the consensus expectations shifted towards a soft-landing in the US and normalizing inflation. However, one must nuance this bullish backdrop since this enthusiasm has been primarily concentrated in a select number of industries which are deemed to be the upcoming beneficiaries of the ongoing artificial intelligence (AI) revolution. Investors indiscriminately bought semiconductor manufacturers, hyperscalers (think Microsoft, Google or Amazon's AWS), data center equipment manufacturers, AI-driven software editors and even some utilities while at the same time overlooking the rest of the market. From a factor perspective, capital has predominantly flood into large/mega cap technology-related names while small caps and value stocks had lost investor interest (the momentum trade, see Chart 1). Similarly, the S&P 500 index has broadly outperformed the S&P 500 Equal Weighted index in 2024 (+15.78% and +8.64% respectively year-to-date as of end of July) due to the overwhelming influence of the index's largest holdings.

Chart 1 – Large cap technology stocks have widely outperformed the rest of the market



Source: Bloomberg, as of August 9th, 2024

In fact, the top 10 holdings of the S&P 500 index currently account for about 35% of the index weight compared to an historical range of 15%-25%. Moreover, most of these names are today part of the same trade/investment theme which tends to amplify price action, both on the upside and downside. Add to that the domination of passive flows in the stock market and you get some valuations getting close to bubble territory despite the undeniable potential of AI across various aspects of our lives. However, besides the appealing narrative, investors must reconsider the current parabolic price actions against the actual revenue growth in the AI ecosystem and multiple other challenges[1]. In any case, the road ahead is still long and some of the current market frenzy is likely unsustainable.

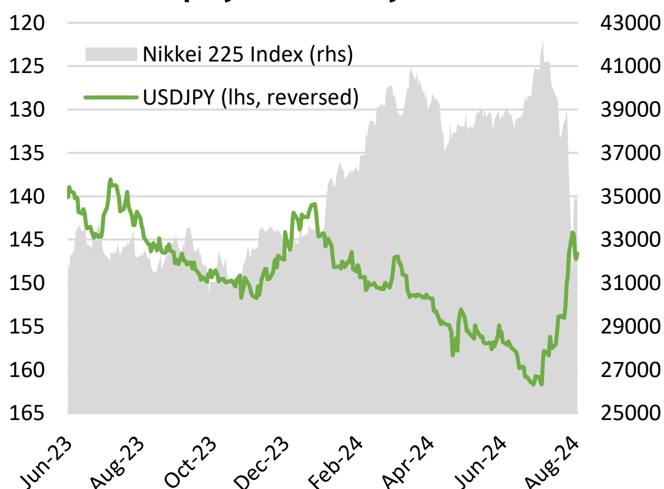
The consequence of such imbalances and extremely narrow market breadth is often the same: a brutal unwind of crowded and often leveraged bets. Long "Mag7" has probably become the most over-owned position in the planet currently driven by a very compelling AI narrative. The resulting dynamic is that such positioning becomes essentially short volatility and highly vulnerable to any forced deleveraging or regime shift. The rotation came in July, when investors started to aggressively reduce their momentum exposure at the benefit of value and small/mid-caps. This reversal did not only hurt traditional equity investors as several hedge fund managers had also piled into this theme motivated by enticing profits and virtually low volatility.

Up until the recent events, financial markets have been assuming and pricing a soft landing supported by resilient growth and falling inflation. However, the ongoing earnings season has already delivered some early signs of consumer pressure in the United States as multiple consumer-facing companies across staples, airlines, automobiles, or luxury goods are cutting guidance and signaling deteriorating demand. Furthermore, the release of a weaker-than-expected employment data for July (NFP +114,000 vs. 175,000 expected) spooked a panic among investors and

suddenly a more acute slowdown in the economy becomes a possibility. Amidst thin summer liquidity, the immediate reaction was an equity sell-off on August 2nd alongside a material rise in rate cut expectations for the rest of the year. In the middle of this turmoil, credit spreads repriced wider but remain rich compared to historical levels. All in all, markets had a rollercoaster week of August 5th as traders first rushed to dump their stocks before clawing back losses after a reassuring, US jobless claims report which helped soothe fears of imminent economic slowdown.

In Asia, the implosion of the yen carry trade in August has sent a massive shockwave across global capital markets. For years, this strategy has been very popular among investors looking to harvest the interest rate differential between the Japanese yen and other currencies (primarily the US dollar). After dropping to the 160 level against the USD in late June, the Japanese currency started to rise sharply in the second part of July and into August (see Chart 2) driven by a larger-than-expected hike by the Bank of Japan (BoJ). The subsequent extreme price action signaled a substantial position reduction in one of the biggest carry trades in the world. In parallel, the BoJ decision sparked an equity meltdown with the Nikkei 225 index collapsing by -12.40% on August 5th, its biggest one-day drop since 1987 after having been one of the best performing markets in 2024 (+27% at peak on July 11th). Ensued a swift recovery in both equities and the USDJPY cross with the BoJ sending a dovish signal to ease market participants.

Chart 2 – Japan witnessed sharp reversals in both the equity and currency markets



Source: Bloomberg, as of August 9th, 2024

Naturally, these recent developments highlight the risks of crowdedness in the current market environment. It also sheds light on the correlation risk as many portfolios become eventually concentrated around one main risk due the swift increase of correlations between different consensual trades when volatility surges. We also need to flag the increase in supply of volatility (notably from banks' Quantitative Investment Strategies (QIS) desks and Alternative Risk Premia strategies), which has participated in suppressing volatility over the past year, in both implied and realized terms. This widespread complacency into a "short vol" positioning has been associated with several downturns in the past, but markets tend to have a short memory to pursue short-term gains at the risk of building up future fragilities.

As long-term investors, we believe that a critical aspect to survival in the financial markets is to reduce the risk of large losses. For this specific purpose, we favor a diversified exposure to hedge funds as a solid risk mitigator. First, such allocation offers investors exposure to uncorrelated strategies to diversify away from traditional risk factors and themes they already own in their portfolios. Second, one should always ensure that the underlying strategies held in any hedge fund allocation are themselves uncorrelated to one another with a strong focus on asymmetrical returns. Nonetheless, uncorrelated strategies tend to underperform when markets lack volatility and are only focused on a handful of themes like it has been the case since last year. However, the embedded long volatility profile of many hedge funds makes them highly valuable assets to own in periods of stress. Looking forward, we remain excited about the outlook for hedge funds given the large number of dislocations and imbalances we observe across all asset classes.

If you have any questions, or would like to discuss about our strategies, please do not hesitate to reach out.

[1]https://www.sequoiacap.com/article/ais-600b-question

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