LMCG INVESTMENTS

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## Unfiltered Special Edition: Update on Market Correction

## It's Not About Technology or Index Funds

The abrupt drop in the US stock market has pulled down much of the world's financial asset prices. Most notable about this fall is that bond prices have been falling in advance of the stock decline, something missing from market corrections for nearly a decade. Headlines today tout the fear of inflation and US Federal Reserve plans for rate increases for the pullback.

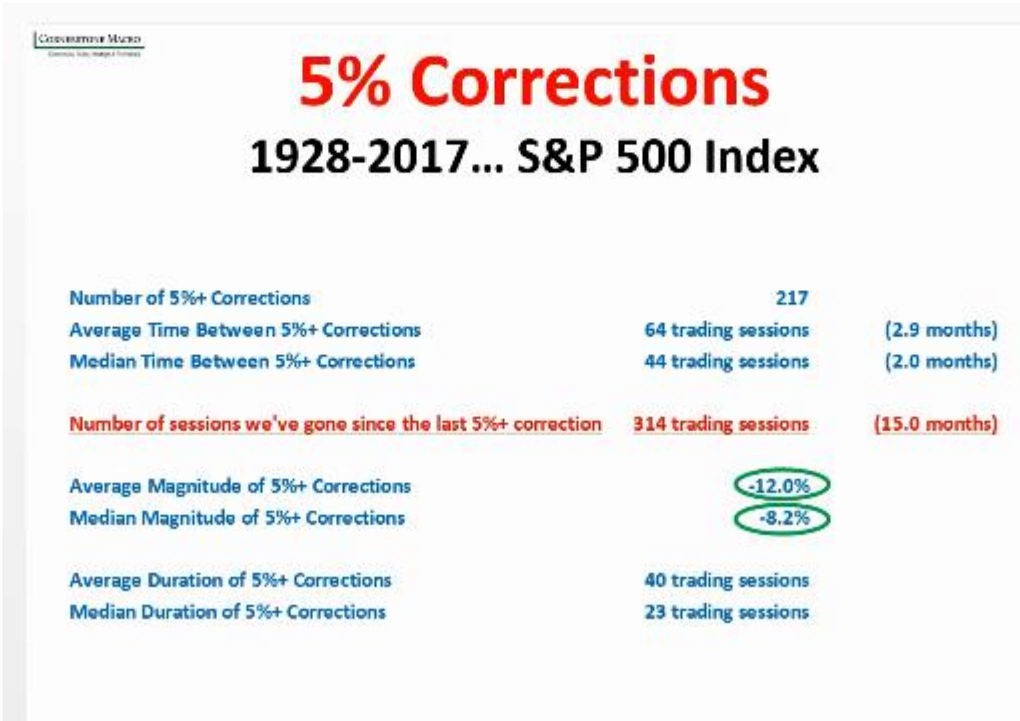
So far, what has been lost have been the gains from 2018 in the equity markets, which, frankly, few analysts could justify anyway. But the momentum of a selloff is not necessarily governed by fundamentals. To formulate a good strategy, and disruptive markets like this require a good strategy, we argue that it is the pervasive 'not losing as the path to winning' philosophy ingrained since the 2008 market crash, is behind the rapid selloff.

Market action on Monday was uniform, widespread and indiscriminate. We call it indiscriminate because the difference between assets that would typically be sensitive to interest rate increases were falling at about the same magnitude as those that would be insensitive. Globally, safe harbor investments like gold and the Japanese yen have seen modest appreciation. It is the VIX index - the market volatility index - that can be used to hedge downside risk^, which has risen dramatically. At this point, market analysts believe that some of that jump was related to short covering by hedge funds.

**<u>VIX Move is the Center of Attention on Tuesday</u>**


**Source: Bloomberg**

__Historical Perspective on 5% Corrections – This One Happened Quickly, But Isn't Unusual__



# 5% Corrections
## 1928-2017… S&P 500 Index

| | | |
|---|---|---|
| Number of 5%+ Corrections | 217 | |
| Average Time Between 5%+ Corrections | 64 trading sessions | (2.9 months) |
| Median Time Between 5%+ Corrections | 44 trading sessions | (2.0 months) |
| Number of sessions we've gone since the last 5%+ correction | 314 trading sessions | (15.0 months) |
| Average Magnitude of 5%+ Corrections | -12.0% | |
| Median Magnitude of 5%+ Corrections | -8.2% | |
| Average Duration of 5%+ Corrections | 40 trading sessions | |
| Median Duration of 5%+ Corrections | 23 trading sessions | |

**Source: Cornerstone Research**

While it is difficult to get a sense of how deep this fall will go Tuesday, the volatility should be very high for the next several days. The market may be structured to intensify that volatility because of the motivations of hedge fund managers and defensive investors. The 'not losing as the path to winning' philosophy has bred investment managers who MUST outperform and protect a big equity market fall by mandate of their investment philosophy. Over the past several years, strategies that have relied upon market timing, insurance strategies, derivative protection strategies, and short trading have lagged simple long-only investing-in many cases by wide margins. These protection-oriented managers MUST provide downside protection for the sake of their mandates and for the preservation of their business. In some cases, where these strategies are structured like the infamous "portfolio insurance" strategies of the 1987 market crash, selling intensifies as price decline momentum increases.

And as we learned in the 1987 crash, and many times since, computers and indexes are simply the tools by which these strategies execute. They don't cause bear markets. (They have caused brief flash crashes, but that is not what is happening over the past few days.)

With that background and cautionary comment, we believe it doesn't feel like a major sustained selloff is under way. While the US stock market has been in somewhat expensive territory recently, valuations are standing on top of solid fundamentals from corporations and wage earners alike. What is more likely to be discussed is the policy impact of a fairly large tax cut while markets and economic fundamentals are strong. Was it a good idea or not? This will be a debate for some time ahead, but it isn't likely a reason for the end of an economic expansion.

^Some investors have taken the other side of the VIX trade – and have sold short volatility – believing that market volatility would stay low/decline for the foreseeable future.  Unfortunately, this strategy did not end well:

**Credit Suisse to Redeem Volatility Note After Value Plunges**

- ETN mirrors the inverse performance of the Cboe vol index
- The bank has not suffered any trading losses related to notes

By Jan-Henrik Förster

(Bloomberg) -- Credit Suisse Group AG is buying back one of its exchanged-traded notes after volatility soared, triggering losses for the holders who had bet on muted market swings.

The notes mirror the inverse performance of the Cboe volatility index, which on Monday soared by the most on record, and will be called on Feb. 21, the bank said in a statement Tuesday. The VelocityShares Daily Inverse VIX Short-Term ETN, known by its trading symbol XIV, dropped 14 percent during the session on Monday and its net asset value plunged more than 80 percent in late trading, according to data compiled by Bloomberg.

**Source: Bloomberg**

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