Global Asset Management

Recent Market Moves: Putting the Week in Context

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Given the volatile week in US markets here are thoughts to help clarify the events of the past few days.

What Happened Last Week?

- Monday, February 5 – the blue-chip Dow Jones Industrial Average (DJIA) posted its largest-ever, single-day point decline, closing down 1,175 points (the equivalent of a 4.6% drop, the biggest such one day percentage move since August of 2011); all other major US indices followed suit, closing at or near session lows
- Tuesday, February 6 – following overnight weakness in US futures, the DJIA opened down 2.3% before ending the day up 2.3%; the intra-day swing resulted in the DJIA advancing 1,167 points from trough to peak
- Wednesday, February 7 – the DJIA finished down a mere 19 points but the intra-day volatility did see the blue-chip index swing by approximately 400 points
- Thursday, February 8 – selling pressure returned and the DJIA fell 1,032 points, or 4.15%
- Friday, February 9 – the morning saw the DJIA advance 1.5% but by noon the average was down 1.2%, a swing of 2.7% or 730 points; after a strong late-afternoon rally the blue chip index finished the day up 1.4%, advancing over 800 points in the final few hours of the session

Notable Observations from our Trading Team

- DJIA declined 600 points in 6 minutes
- Largest one-day spike in CBOE Market Volatility (VIX) ever (+115%)
- S&P 500 registers 404 days without a 5% correction over, longest such streak
- Market liquidity was lower this week than during the May 6, 2010 Flash Crash
- Extreme volatility in Exchange Traded Funds/Notes (ETFs/ETNs)

Markets and Liquidity

The market was very orderly last week despite all the volatility. There was no panic. Exchanges didn't fail. Market participants did not experience connectivity issues. The market operated quite well, actually, and did so within the context of current regulation and market structure.

On Monday, the consolidated US market traded ~11.5 billion shares. During the Flash Crash the market traded ~19.2 billion shares. Although Monday's volume was ~55% above the 20-day average, that puts the move in context, and speaks broadly about the volume last week. Last week was all about follow the leader. It didn't matter how fast you were to sell just as long as you were faster than the next participant. And that's another important point, volume and liquidity are two completely different things. Last week liquidity evaporated.

There were plenty of other anomalies that took place too. Trading desks watched the 10-year drop from about 2.8% to 2.7% in a tick. The DJIA dropped ~600 points in a matter of minutes. On Wednesday, retail securities websites crashed due to traffic volume. The point is, multiple standard deviation events took place on a daily basis last week.

Some investors do not understand the risks associated with ETFs and ETNs, let alone inverse and levered products. Take for example the XIV, an ETN product designed to track the inverse of volatility. On Monday, the VIX (a measure of market volatility) was up ~115%. Conversely the XIV was down $95%. To put that in perspective, the XIV was valued at ~$120 on Friday, February 2 and closed at $5.38 on Friday, February 9. Coupled with the violent advance of the VIX, and the general correlation of ETFs/ETNs and underlying securities, the deterioration of the XIV seems to have had a direct impact on broader market movements.

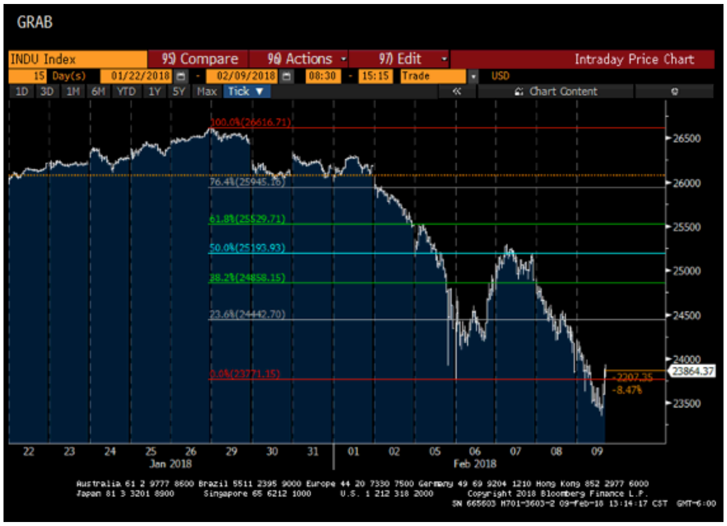
This recent market downturn seems at odds with fundamentals. Employment is on a record pace, wages are growing, GDP is up over 1% in the past several quarters, the global economy is recovering quite well, and corporate earnings are strong. The economy is fundamentally in good shape – maybe too good – and perhaps the market got ahead of itself.

The underlying message for investors today is to remain calm and see where this all plays out. Short term movements should not be the underlying reasoning behind investment decisions but they can provide an excellent opportunity. For our teams and strategies, that holds especially.

In our opinion the selling won't abate until sustained declines of ~10% are registered on the major US indices – then participants can call it a "correction" and start to rebuild. So fluid was the week, however, that declines of more than 10% were briefly reached earlier in the week and the major US indices actually retraced ~50% of the losses before retreating on February 8 to newer lows. Do markets rebound from here or are participants still trying to validate the worst is over?

The chart below shows the DJIA over the past 15 days, through early Friday afternoon.

Exhibit 1



Source: RBC GAM-US, Bloomberg