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What's going on? Tallying the technicals

Blog

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So much for the consensus view that the first half of 2023 will be difficult before giving way to a better second half. The strong start to the year for almost all asset classes hasn't let up (Fig. 1), while the VIX volatility index fell briefly below 18 last week, its lowest level since January 2022. Many of the biggest equity decliners in 2022, such as unprofitable tech, are the leaders in 2023, and cyclical sectors are trouncing defensives. Certainly, the fundamental factors of China's post-COVID reopening, improving Eurozone prospects, and US labor market resiliency have buoyed this rally. But technical factors are equally important for understanding what's going on across markets.

First, investors in aggregate were lightly positioned in risk to start the year, a consequence of concerns surrounding slowing global growth and an earnings recession. That has started to change. Systematic strategies are adding risk, while hedge funds are not just covering shorts, but starting to add new longs. The put-call ratio on S&P 500 index options has climbed significantly since November, an indication of more hedging of new positions, which is consistent with the increase in net longs in S&P 500 futures.

Second, there has actually been retail outflows from US equity ETFs, most notably from tech, growth, and Nasdaq ETFs. This stands in stark contrast to massive equity ETF inflows at the start of 2021 and 2022. It's also in contrast to inflows into European and emerging market funds. But the decline has been more than offset with retail buying of single name stocks in January, reminiscent of activity two years ago, lifting the NYSE FANG+ index 20% YTD.

Third, a preference for carry trades is clearly evident in fund flows. Over USD 100bn has gone into US money market funds, which now hold a staggering USD 4.8tr, and about USD 50bn into fixed income funds, with 40% of that in investment grade and high-yield corporate bond funds. The attraction to carry is obvious, with yields ranging from mid- to high-single digits for the first time in years, versus equities with significant earnings risk. A byproduct of these flows is that it has created demand for new supply, which has already totaled USD 14.2bn of high yield in January.

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Fig. 1: The strong start to 2023 continues
Asset class total returns

	YTD
Cash	0.3%
US government	2.3%
US Treasuries (long)	6.5%
US TIPS	2.4%
US municipals	2.8%
US IG credit	3.6%
US high yield	3.9%
EM USD FI	3.3%
EM LC FI	4.0%
MDB Bonds	1.4%
Global Equity	7.4%
US All-cap	6.6%
US large-cap growth	8.3%
US large-cap value	4.8%
US mid-cap	7.6%
US small-cap	8.6%
Int'l dev equity	8.6%
EM equity	10.0%
Preferreds	8.6%
US Real Estate	9.9%
Senior loans	2.9%
MLPs	7.6%
Brent Crude	0.9%
Gold	5.7%
Broad Industrial Metals	7.2%

Source: Bloomberg, UBS, as of 27 January 2023

Fourth, investors have also been turning to long duration assets, which is as much about hedging as it is about yield. With concern shifting from inflation to growth risks, there is a greater desire to own long bonds to diversify equity risk in multi-asset portfolios. That didn't work in 2022, but there are tentative signs that the correlation between S&P 500 and Treasury bond returns is turning negative again. There's also likely to be significant pension fund demand for long duration bonds as they seek to de-risk their portfolios now that they're more than fully funded. Finally, economic growth risks that are spurring interest in long duration may be helping the performance of growth stocks this year.

Finally, implied volatility for US equities and bonds alike have fallen to levels last seen in 1H22. A Federal Reserve that's close to being done with rate hikes and investor confidence that inflation will continue to decline are bringing rate volatility down. That should help lower volatility in other asset classes, and in turn, encourage increased risk taking.

The bottom line: Technicals have played a large role in market performance so far in 2023, providing a tailwind for almost all asset classes. That's likely to continue in the very near term, barring a surprisingly hawkish FOMC

meeting on 1 February. But the influence of positioning and flows is likely to wane as they always do, with fundamentals resuming as the dominant driver. Moreover, risk premia in general are less attractive now than they were just four weeks ago. Thus, investors should favor those assets, such as EM equities, that have fundamentals in their favor, and be cautious on assets that have been the biggest beneficiaries of technical flows, such as growth and tech equities.

Appendix

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