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All-time highs mask ongoing market risks

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Confidence remains high among equity investors, as the S&P 500 continues to hit fresh record highs. But economic and geopolitical risks remain. Investors can consider various strategies to minimize volatility and drawdowns, including adding defensive structured strategies, alternative investments, or positions in oil and gold.

US equities opened the week with a fresh all-time high after a cut in the quarterly borrowing estimate by the US Treasury pushed bond yields lower. Markets are also anticipating significant earnings growth from mega-cap technology companies that report this week, along with further indications from the Federal Reserve policy meeting that US interest rate cuts are on the way. Both the S&P 500 and the Nasdaq Composite indexes are 3.3% higher than the start of the year. Meanwhile, the VIX index, a popular measure of fear among US equity investors, stands at around 13.3—well below the long-run average of close to 20.

However, despite the recent optimism, several key risks remain, underlining the importance of considering strategies to reduce threats to portfolios.

The conflict in the Middle East and the war between Russia and Ukraine have the potential to cause bouts of volatility. US Secretary of State Antony Blinken warned that the Middle East faces its most “dangerous” conditions in 50 years as Washington vowed to retaliate after three US troops were killed in a drone attack in Jordan. The attack was the first deadly strike against US troops, and it marked a major escalation in tensions in the region since the Israel-Hamas war began in early October. While Blinken insisted that the US wanted to “prevent broader escalation,” he said the US response could be “multi-leveled, come in stages, and be sustained over time.” At the same time, the war in Ukraine shows no signs of ending, with ongoing concerns that the conflict could potentially disrupt international trade.

US-China relations are likely to remain in the headlines in the lead-up to the US presidential election. The recent meeting between China's top diplomat Wang Yi and US National Security Advisor Jake Sullivan was reported to be "candid" and "substantive," with an agreement to maintain open lines of communication and a future call between Chinese leader Xi Jinping and US President Joe Biden. However, with the US presidential election in early November, and former President Donald Trump leading the Republican primaries, headlines surrounding US-China tensions could spur market volatility. In recent days, proposed US legislation seeking to block some Chinese biotech companies with alleged military ties have impacted Chinese equity markets. In addition, Trump has reportedly discussed the possibility of imposing a 10–60% tariff on all Chinese goods if he's reelected.

More-hawkish-than-expected Fed communication could lead to a correction in policy expectations. Our view is that the Fed is likely to open the door further to rate cuts at its policy meeting on Wednesday, while leaving rates on hold this month. But recent solid growth and labor data from the US suggest the Fed will likely not rush to start cutting rates at the pace markets currently expect. The 140 basis points of rate cuts already priced in by markets for 2024 seems excessive to us—our base case is for 100 basis points of easing, likely starting at the May meeting. Any hawkish comments from Fed Chair Jerome Powell following the central bank's policy meeting could lead to a pullback in market rate-cut expectations and risk appetite. US payrolls data for January, which will be released on Friday, could also add to volatility if the rate of job creation or earnings growth is stronger than the consensus forecast.

So, while no form of protection works for all risks, we see a range of strategies that can help mitigate volatility or drawdowns for portfolios. These include seeking quality in both equity and bond holdings, as well as defensive structured strategies, alternative investments, or positions in oil and gold.

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