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The Market Sell-Off: Justified or an Overreaction?

Amid slowing growth and a sharp global sell-off, allocators may want to pay attention to these three factors.

Nanette Abuhoff Jacobson
Managing Director and Multi-Asset Strategist at Wellington Management and Global Investment Strategist for Hartford Funds

The broad market sell-off is still evolving, but it's a good moment to review the catalysts, the technicals at play, the fundamental picture, and what, if anything, allocators may want to consider doing. As of this writing, over the past three days, the Nikkei 225 Index[1] was down 20%, the yen was up 4.5%, the S&P 500 Index[2] was down 4%, high-yield spreads[3] were wider by around 50 basis points (bps),[4] and the US 5-year Treasury yield was down around 35 bps. Bottom line: I think markets may have overreacted relative to the fundamental backdrop.

Catalysts — As is often the case with significant sell-offs, this one has been driven by a confluence of factors. At the top of the list is the increase in the US unemployment rate from 4.1% to 4.3%, the Bank of Japan (BOJ) rate hike of 15 bps, and fear of a policy error by the Federal Reserve after it opted not to cut rates at last week's Federal Open Market Committee meeting. Other concerns include some megacap tech earnings disappointments, the expanding Middle East conflict, and lower odds of a second term for former President Donald Trump after Vice President Kamala Harris entered the race as the likely Democratic candidate.

Technicals — A long period of benign, trending markets is an encouraging sign for investors looking to add risk. But when volatility spikes and trending markets reverse direction, forced selling may be triggered, which can exacerbate the moves as selling begets more selling (**FIGURE 1**). Selling by hedge funds and systematic strategies appears to have played a large role in the magnitude of the sell-off. Hedge fund gross leverage has been running at higher-than-normal levels. So-called "CTA" and "vol-managed" approaches, which "automatically" de-risk during sell-offs, seem to have played a sizeable role. Also, yen appreciation caused unwinds of yen carry trades where the cheap yen is sold to fund investments in higher-yielding instruments.

Fundamentals — The US employment picture has been weakening but isn't, in my view, cause for panic. A host of indicators have been showing the labor market normalizing from overheated conditions, including fewer job openings and lower quit rates, slower hiring rates, and lower wage increases. As of this writing, 75% of companies have reported Q2 earnings that have surprised to the upside across all sectors. The consumer sector has disappointed as consumers, especially the lower-income cohorts, have gotten squeezed by high prices and are pulling back. We're watching credit-card data that suggest consumer weakness has been migrating to higher-income consumers. As noted, tech earnings have been closely scrutinized and there have been some disappointments relative to expectations, but the long-term earnings growth trajectory remains intact, in my view.

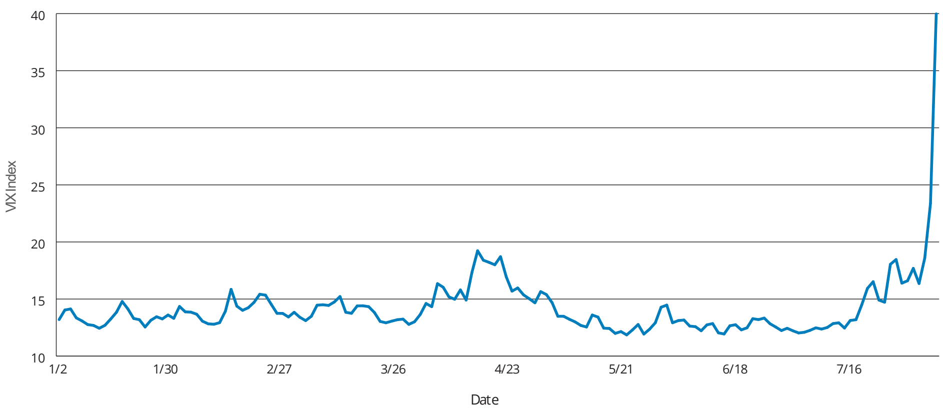
Key Points

- While a broad market sell-off is still evolving, markets may have overreacted relative to the fundamental backdrop.
- The US employment picture has been weakening but isn't, in my view, cause for panic. A host of indicators have been showing the labor market normalizing from overheated conditions.
- Though there has been some deterioration in fundamentals, I think the sell-off is being exacerbated by technicals.

FIGURE 1

Technicals Contribute to a Spike in Volatility

VIX Index (1/2/24-8/5/24)



Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. The VIX Index is a financial benchmark designed to be an up-to-the-minute market estimate of the expected volatility of the S&P 500 Index and is calculated by using the midpoint of real-time S&P 500 Index (SPX) option bid/ask quotes. For illustrative purposes only. Data Source: Bloomberg, 8/24.

Investment Implications

- While there has been some deterioration in fundamentals, I think the sell-off is being exacerbated by technicals. Central banks are also in a good position to lower rates and cushion the economy if fundamentals deteriorate meaningfully. On balance, I think this could be an opportunity to add risk in equities and credit, though it's important to be mindful that technicals may need some time to normalize.
- The rally in US rates may warrant a pause in long-duration[5] positions. Given that almost 125 bps of rate cuts are being priced by year end, I would consider turning neutral on duration and waiting for a better entry point to go long again.
- The sell-off in Japanese equities, in particular, seems like an overreaction to the BOJ's rate hike. I would consider this an opportunity to gain exposure to this market.
- Remember the long term. While volatility can be unpleasant, these are also times to step back and consider what has really changed. To the extent that fast-acting players or strategies are forced to sell, this can be viewed as an opportunity for allocators with multi-year investment horizons.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

[1] Japan's Nikkei 225 Index is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange.

[2] S&P 500 Index is a market capitalization-weighted price index composed of 500 widely held common stocks.

[3] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

[4] A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

[5] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • US Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest.