When Markets (or the Fed) Surprise – Market Commentary

October was a negative month across global markets driven by further US Treasury yield increases. The 30-year yield rose above 5.0% for the first time, to 5.1%, having started the month at 4.7%, while the 10-year Treasury rose from 4.6% to 4.9%.

The S&P 500 and the Nasdaq declined -2.1% and -2.0% respectively. Somewhat unusually, the MSCI Value Index underperformed the MSCI Growth Index at -3.4% vs -2.4%. We had become accustomed to Growth underperforming in a rising rate environment. The Value underperformance may have to do with recession expectations – equity prices are driven by interest rates and earnings growth and while both Growth and Value declined, Value may have declined more due to expectations of inferior future profitability in the event of a slowdown.

Emerging Markets underperformed Developed Markets returning -3.9% vs the MSCI World's -2.9%, and South Africa mildly outperformed Emerging Markets at -3.0% in USD terms (-3.4% in ZAR).

The various market returns are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for September 2023*

	Oct-23	YTD 2023
FTSE/JSE ALSI (ZAR)	-3.4%	-1.3%
FTSE/JSE ALSI (USD)	-3.0%	-10.4%
MSCI World	-2.9%	7.9%
MSCI EM	-3.9%	-2.1%
MSCI Value	-3.4%	-1.5%
MSCI Growth	-2.4%	17.9%
S&P 500	-2.1%	10.2%
Nasdaq 100	-2.0%	32.6%

*Total return indices, Source: Factset

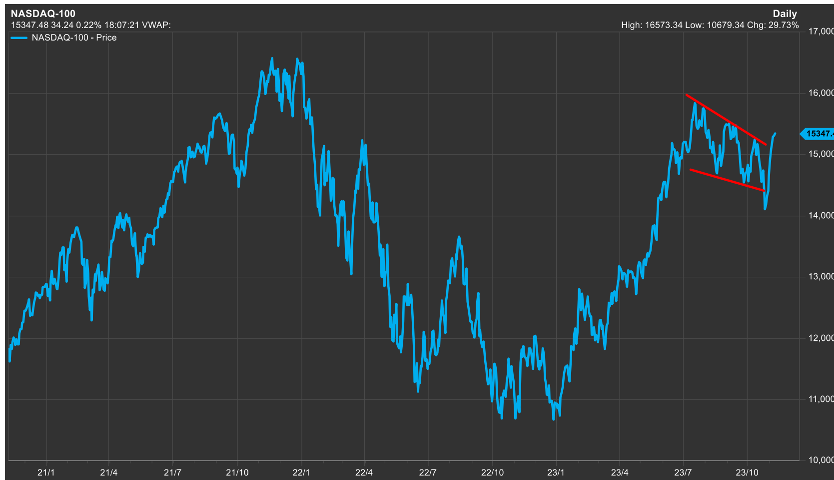
October / early November was an interesting month in that it provided a case study both in how macro forecasting may throw up surprises and also how technical analysis can go wrong.

What happened?

Chart 1 below sets out the movement of the Nasdaq 100 over the last 3 years. We use the Nasdaq as an example although the same pattern of movement was evident in the S&P 500. We pay particular attention to the last 3 months but discuss a 3-year chart because the last 3 month's movements are better contextualised.

From Chart 1 below we can observe that since August the market had been trading in a somewhat narrowing, declining channel. September and October are traditionally negative months, and while economic data remained resilient, expectations of a recession mounted. Sentiment appeared reasonably strongly negative.

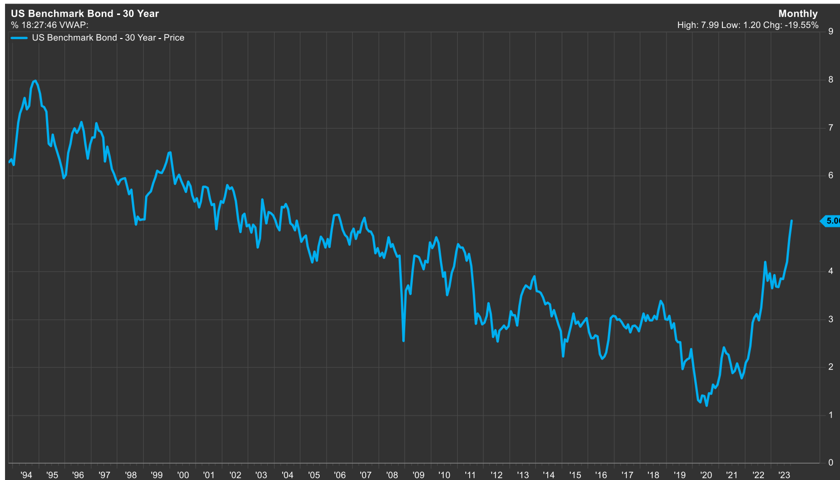
Chart 1. Nasdaq 100 over the previous 3 years



Source: Factset

Chart 2 below sets out the consistently rising US Treasury yields which were increasing pressure on market prices. This is also a longer-term chart since it better conveys the context for the more recent rising rates i.e. the multi-year bond bull market and its sharp reversal).

Chart 2. US 30-year Treasury Yield



Source: Factset

So during the last 3 months rising rates and recession expectations suggested further market declines.

Technical analysis

We do not much believe in technical analysis. Yet common technical analysis patterns arise time and again in different markets and situations. There is no regularity to this, and there is no certainty that an anticipated movement will materialise (as happened in this case), yet the patterns seem to reappear time and again.

We hesitate to use the terminology of the trade (pun) but the declining channel in Chart 1 above for the Nasdaq could variously be interpreted as forming a pennant, a triangle or a wedge, or any other term of your choice for that matter. Further, the base of the channel is commonly referred to as a support line, while the top is considered a line of resistance.

The important part to all of this is that should the price "break out" of its established pattern, a sharp decline can be expected. In this case given the bearish sentiment, a breakout to the downside appeared likely and this duly arrived towards 25 October. Suddenly the stage appeared set for a sharp market decline.

The Fed Meeting

Then the Fed meeting on October 31 arrived and the FOMC did not raise the Fed Funds rate in early November. This clearly surprised the market. Treasury yields reversed course and dropped sharply - the 30-year Treasury fell back below 5%, retreating rapidly towards 4.6%. The equity market rallied equally sharply, reversing its previous bearish trend, its breakout on the downside broken, and returned +8.5% in short order. In technical analysis terms it appeared to, in turn, break out on the *upside*.

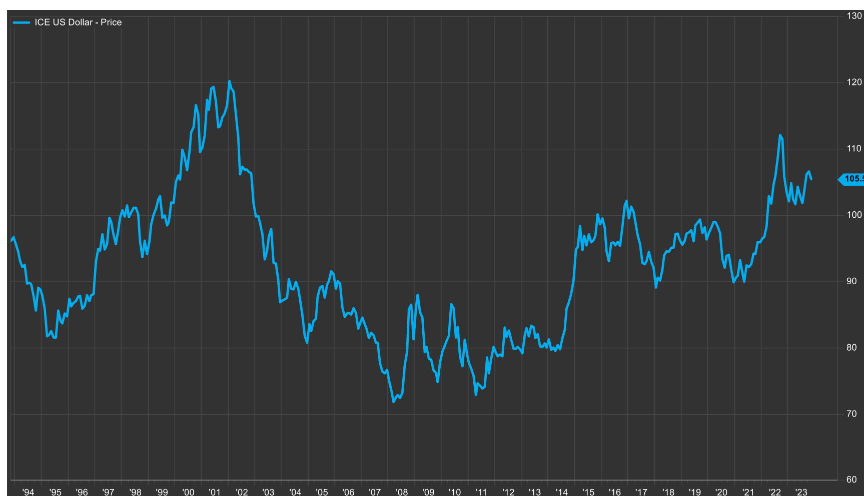
Can we draw any lessons?

This short but illuminating episode suggests two points

1. macro forecasting is difficult – any portfolio positioned for yield increases and/or equity market declines, and/or USD strength for that matter (the DXY Index set out in Chart 3 below, again, from a longer-term perspective, suffered a quick 2% decline) was surprised and suffered a setback.

2. technical analysis is difficult – a clear pattern had arisen and equity market indices (the S&P 500 as well as the Nasdaq) were responding as conventionally expected, until they weren't. The established technical trend in the equity market suffered a swift reversal and we expect many technical traders suffered losses.

Chart 3. DXY (USD) Index



Source: Factset

What works?

All strategies in financial markets carry risks. We are amateur macro watchers. As is evident from this commentary we are also occasional amateur technical pattern watchers. We also feel we recognise at least some of the dangers. We would not consider technical trading as a viable strategy under any circumstance (though, again, as noted, technical patterns do seem to arise regularly). Macro investing is perhaps better, being grounded in fundamental information. As illustrated however, it is also subject to surprises and sudden reversals.

For the purposes of managing funds, we feel the greatest safety in financial markets arises from investing in assets with consistent underlying operating performance. Market prices fluctuate – at times they can decline sharply e.g. in 2022, at other times they might rise too far too fast. Sooner or later however they have to reflect the performance of the underlying asset, and a good asset is typically rewarded with a rising price. Internationally there is a wide selection of good assets to choose from. The chances of negative surprises, while not zero, are lower, and mitigated in a diversified portfolio. Over the long term we feel such assets provide rich opportunities for outperformance.