WHAT ASSET CLASS RALLIED LAST WEEK AMID THE SELL OFF?

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Last Thursday's sell-off in U.S. stocks (the Dow was down 317 points, the S&P 500 Index was down nearly 2%)[1] marked the biggest stock market decline in nearly four months[2]. The S&P 500 Index closed at 1,930 after it broke its 50-day moving average for the first time since April[3]. With volatility rising and sentiment shifting, I would not be surprised to see the S&P 500 test its 100-day moving average (1,910) and, if pierced, its 200-day moving average at 1,857 (roughly a 4% decline from Thursday's close). Although headlines from Thursday regarding Argentina's default on roughly $500 million in interest payments[5] spooked the bond markets, the more important event that day may have been the higher-than-expected print on the Employment Cost Index, which increased to .7% in the second quarter[6]. Fed chairman Janet Yellen's zero interest rate policy (ZIRP) hinges on the perception that inflation is not on the horizon and that the labor market still has plenty of slack. Though continued job growth and a pickup in wages would be good for consumer spending and the overall economy, it could also indicate that the Fed is behind the curve with respect to how quickly the labor market is tightening and how soon higher inflation, spurred by increased labor costs and a policy of easy money, may ripple through the economy. Each day is a tug-of-war, but if fresh data in the weeks ahead leads market participants to believe that the Fed will move sooner rather than later to raise policy rates, I believe that a repricing of assets may occur in the third quarter, rather than three to six months from now. What made Thursday's action equally troubling to many who manage money is that most asset classes bled red on the same day. When assets that are not supposed to correlate all decline in tandem (stocks[7], bonds[8], gold[9], commodities[10], U.S. government debt[11], emerging market debt[12], investment-grade credit[13], high-yield credit)[14] investors are reminded what it means to have a truly diversified portfolio—and how difficult it can be to create one. One of the few indexes to rally on Thursday amid the sell-off was the Bloomberg Dollar Index (BBDXY). The Index, which tracks a basket of 10 foreign currencies in the developed world and the emerging world, rose in value, reflecting the U.S. dollar's relative strength in a world where "risk" was coming out of the market. This makes sense. Fears of higher rates would hurt bonds but could make the U.S. dollar look more attractive, particularly compared to developed world currencies where central banks will likely be accommodative for far longer than the U.S. Federal Reserve. In the chart below, you can see how the Bloomberg Dollar Index (in white) has rallied over the last two months, particularly as the S&P 500 Index weakened toward the end of July.

BBDXY Index refers to the Bloomberg Dollar Index. SPX Index refers to the S&P 500 Index.
Source: Bloomberg, with data from 5/30/14 to 7/31/14. Period chosen to indicate the difference in performance of BBDXY Index during a time of rising U.S. equities contrasted with the one-day significant decline. This is a short-term period, and investors should recognize that short-term periods can be volatile.
Past performance is not indicative of future results. You cannot invest directly in an index.

For investors looking for a way to hedge the impact of a sudden change in market sentiment, gaining exposure to the U.S. dollar relative to foreign currencies may make a lot of sense as a tactical holding until the market fully absorbs the Fed's intention and the timing of its eventual liquidity-curbing actions[15].

[1]Refers to the price behavior of the Dow Jones Industrial Index and the S&P 500 Index for the 7/31/14 date. [2]Source: Bloomberg, with the last one-day decline of the S&P 500 Index of 2% or more occurring on 4/10/14. [3]Source: Bloomberg. The last day the S&P 500 Index broke its 50-day moving average was 4/10/14. [4]Source: Bloomberg, for both 100- and 200-day moving averages, measured as of 7/31/14. [5]Source: Camila Russo & Katia Porzecanski, "Argentina Declared in Default by S&P as Talks Fail," Bloomberg, 7/30/14. [6]Source: Sam Ro, "Traders Are Blaming Thursday's Big Sell-Off on 1 Stat," Business Insider, 7/31/14. [7]Refers to S&P 500 Index. [8]Refers to Barclays U.S. Aggregate Index. [9]Refers to the price of gold, measured in U.S. dollars (not a specific index). [10]Refers to S&P GSCI Index. [11]Refers to the U.S. 10-Year Treasury note. [12]Refers to the J.P. Morgan GBI-EM Global Diversified Composite Index. [13]Refers to the iBoxx $ Liquid Investment Grade Index. [14]Refers to the iBoxx $ Liquid High Yield Index. [15]In this context, liquidity-curbing actions means raising of the Federal Funds Rate, which is the policy tool employed by the Federal Open Market Committee to tighten U.S. monetary policy, potentially slowing the pace of economic growth.

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DEFINITIONS

Dow Jones Industrial Average : The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

50-day moving average : Average of the prior 50 days' worth of price values, with an increasing trend indicating relative strength and a decreasing trend indicating relative weakness.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

100-day moving average : Average of the prior 100 days' worth of price values, with an increasing trend indicating relative strength and a decreasing trend indicating relative weakness.

200-day moving average : Average of the prior 200 days' worth of price values, with an increasing trend indicating relative strength and a decreasing trend indicating relative weakness.

Employment Cost Index : Measure of the change in cost of labor, free from the influence of employment shifts among occupations and industries.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Bloomberg Dollar Spot Index (BBDXY) : Tracks the performance of a basket of ten leading global currencies versus the U.S. dollar. Each currency in the basket and their weight is determined annually based on their share of international trade and FX liquidity.

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Barclays U.S. Aggregate Bond Index, 1-3 Year : This index is the 1-3 Yr component of the U.S. Aggregate index.

S&P GSCI Index : leading measure of general commodity price movements and performance over time.

iBoxx $ Liquid Investment Grade Index : The index is designed to represent a subset of the broader USD corporate bond market which can be used as a basis for tradable product.

iboxx $ Liquid High Yield Index : The index is designed to provide a broad representation of the U.S. dollar-denominated high yield liquid corporate bond market.