Despite the ups and downs of the past two months, U.S. equity markets remain near all-time highs and have experienced surprisingly few bouts of broad market volatility this year, especially considering the very significant moves in other non-equity markets, a shift in central bank policy, and the rising probability of a U.S. recession. However, significant sector rotation and style dispersion have generated meaningful internal volatility in the equity markets. In the past few weeks, U.S. equity momentum and value factors have had their sharpest moves in more than 15 years based on our calculations.

While we believe this internal volatility warrants some caution and defensive equity positioning overall, we think it also presents opportunities for investors. In an environment of slowing profit growth, we believe investors should maintain a defensive high quality bias, and the recent factor volatility offers investors the opportunity to add to that position, in our view.

Why is factor volatility rising?

The rising dispersion and volatility of factor returns can be explained by the lengthy period of slowing economic activity globally, particularly in the manufacturing and trade sectors, which has been met with central bank policy changes. Essentially, investors are responding to these developments by navigating to “winners” and insulating themselves from “losers,” depending on their assumptions on the causes of the economic weakness. This resulted in strong outperformance of the momentum factor and underperformance of value.

We compared factor volatility with the VIX index, a measure of S&P 500 volatility, to show the growing disconnect between the calm on the surface and the turbulence within the equity markets (see box in Figure 1). Historically, when markets experience volatility divergence of this sort, we become more cautious because violent rotations suggest that markets are more fragile than they may appear. To be clear, the divergence doesn’t make broad equity market volatility a certainty, but it does raise the odds and suggests that a higher level of risk awareness is warranted.

![Figure 1: U.S. Equities: Average Factor Volatility Points to Internal Turbulence](image)
For many market participants, the magnitude and speed of the move in factor volatility have been more surprising than its direction. What accounts for such a sudden jump? We think the six-month period of significant factor returns relative to trend in the equity markets left factors vulnerable to short-term mean reversion.

**Investment implications of factor volatility**

Quantitative equity strategies can be designed to seek to weather such volatile periods. Stable allocation to a variety of time-tested factors and dynamic allocation to factors for present macroeconomic environments can both be potentially beneficial for investors. In our recent asset allocation outlook, we favored a modest underweight to equities within multi-asset portfolios with an emphasis on high quality, defensive sectors given the current profit cycle. Now, we think the recent velocity of factor movement presents investors with potential market dislocations – and opportunities to take advantage of them.

**DISCLOSURES**

All investments contain risk and may lose value. Equities may decline in value due to both real and perceived general market, economic and industry conditions. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

S&P 500 Index is an unmanaged market index generally considered representative of the stock market as a whole. The Index focuses on the large-cap segment of the U.S. equities market. The Standard & Poor’s Super Composite 1500 Index is a combination of the S&P 500, Mid-Cap 400 and the Small Cap 600 Indices and is generally representative of 87% of the total U.S. equity market capitalization. The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. It is not possible to invest directly in an unmanaged index.

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