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When the dog bites

After a strong start in 2018, the market experienced a painful bite last week. Investors were stung by a sudden drop which took the PSEi from all-time intraday high of 9,078 on January 29 to an intraday low of 8,380 on February 6. This is equivalent to a 7.7% decline in just six trading days. As we prepare to celebrate the Chinese New Year on February 16, we look back at the blessings that the Fire Rooster brought. At the same time, we explore what is in store for us in the Year of the Earth Dog.

Man's best friend

Among the animals in the Chinese zodiac, the dog is the closest one to humans. Known for its intelligence and loyalty, the dog has become an ideal household pet for many, thus earning the monicker 'man's best friend.' Dogs come in many different breeds and vary greatly in terms of size, build and temperament. This means that dogs can be utilized for different purposes and various activities.

Farewell, Fire Rooster

True to form, the Fire Rooster has brought good fortune to investors as the PSEi gained 25.1% in the calendar year 2017. With four days to go in the outgoing lunar year, the Fire Rooster has delivered a 16% return to the PSEi. Since dogs can significantly vary from each other, it is worth asking if the Earth Dog will be a loyal and domesticated companion or a wild and treacherous beast.

Dog days are here again?

As stocks rallied in early 2018, investors were caught off-guard as extreme volatility recently returned to the fore. The volatility index (VIX), also known as the 'fear gauge', spiked more than 300% from 12 to a high of 50.3, signaling heightened investor anxiety. Below, we enumerate Dow milestones that were touched during the recent market plunge.

1. On Friday, February 2, the Dow fell by an ominous 666 points.
2. Last Monday, February 5, the Dow staged an even more shocking drop of 1,175 points, its biggest points drop in history.
3. On February 6, the Dow swung more than 1,100 points in a single day. From down 567 points at its intraday bottom, the Dow closed 567 points higher for the day.
4. On February 8, the Dow fell by a staggering 1,033 points. This puzzled experts who did not expect the Dow to drop more than 1,000 points twice in a single week.

With the unnerving performance of the market as the Year of the Dog approaches, many are wondering if the dog days are upon us now.

Welcoming the Earth Dog

The Year of the Earth Dog will start on Friday, February 16, 2018 and will last up to February 4, 2019. Much like their animal zodiac, people born on Dog years are honest, sincere and loyal. These characteristics, as well as universal values of solidarity and fairness, are expected to have a significant influence on people this year. But as far as investments during the Dog year are concerned, feng shui experts advise investors to be judicious in their decisions. Moreover, geomancers warn about potential earthquakes, landslides or volcanic eruptions. All these warnings imply heightened volatility in the Year of the Earth Dog. Considering the sharp market gyrations in the past two weeks, investors should thus be careful of the seismic shifts and sudden jolts in the stock market. The PSEi, in its short history, has only undergone two Dog years so far. The PSEi dropped 19.6% in 1994 and surged 57.1% in 2006.

When volatility bites speculators

The recent slump in stocks was triggered by a sudden rise in bond yields and was amplified by algorithmic trading and the speculative frenzy over esoteric financial instruments. This is a far cry from the caution and discipline that investors exhibited in the aftermath of the 2008-2009 global financial crisis. Recently, we saw how naive and neophyte investors threw caution to the wind by pouring hard-earned money into speculative instruments that they do not fully understand. This was manifested in the dizzying rise and massive meltdown of volatility-linked investment products, ultra-leveraged exchange-traded funds (ETFs), complicated exchange-traded notes (ETNs), complex derivative products and cryptocurrencies.

Implosion of reverse volatility products

The ongoing massive crash in the US stock market is now being traced to the speculation of hedge funds and amateur investors in volatility-linked notes. These complex instruments allow buyers to profit from a decline in market volatility. However, these aggressive bets have come back to bite them as volatility erupted in the past two weeks. Most of these short-volatility instruments lost up to 80-100% of their value. Recently, Credit Suisse liquidated its reverse volatility ETN called XIV. Last Friday, Fidelity, one of the largest retail brokerages in the US, issued a trading ban on reverse volatility products. Based on recent developments, we can see that speculating in order to make a quick buck, putting in money due to FOMO (fear of missing out), blindly following the herd or buying esoteric instruments that one does not understand usually leads to disastrous results.

Don’t bite off more than you can chew

As volatility has returned to the forefront, it is an opportune time for investors to revisit their asset allocation and risk management. Before investing on any asset or financial instrument, one must understand, assess and weigh the looming risks vs. the potential reward. Like a loyal guard dog, investors should exercise prudence in their investment decisions. In this light, we continue to advocate focusing on companies with solid business models and strong fundamentals. Doing this will allow one to survive the stinging bouts of volatility and capitalize on the positive long-term trajectory of stocks.

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