Il Sole 24 ORE

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THE ANALYSIS

Behind the scenes of the fall: mechanisms that inflated rally lose ground

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The most entertaining aspect of commenting on the trend of stock exchanges is that anything and everything can be said to explain phenomena that are unexplainable on the surface. Yesterday, the most popular reason on the market to justify the drop in prices was linked to the Fed's disastrous estimates of the American economy's performance. And on Wednesday evening, the US central bank cut its 2020 GDP forecasts to -6.5%. But, if that was the reason for the drop, why had US prices not already dropped on Wednesday evening, if not by zero point something? On the same note, why didn't the markets remain in shock following the previous week's estimates by the ECB on the euro zone economy (-8.7%)? After all, the Fed's numbers are ugly, but the IMF already predicted a 5.9% slowdown in US GDP back in April. And yet, since then, the stock exchanges have staged a super rally. Is it possible that they are still so unsettled by the Fed?

This is clearly not the case. The stock exchanges have been on a run in recent months, despite a global economic scenario that is both disastrous and exceedingly uncertain. They have come unhinged from reality, thanks to the fact that the central banks purchased securities and injected over 5 trillion dollars of fresh liquidity into the markets. Considering that, after the drop in February, all portfolios were rid of risk, this mass of liquidity led to three phenomena in March. One: "forced" buying by those needing to rebalance portfolios. In March, JP Morgan estimated that just to rebalance its asset allocation following the massive shock to the stock exchanges, funds, sovereign funds, pension funds and many parties would have to purchase shares worth 3.3 trillion dollars. Two: the liquidity prompted the start of "opportunistic" buying by all investors who saw the rally strengthened. Three: in recent weeks, with the volatility dropping to a normal level of 20 (VIX index), the algorithms were also triggered.

This instigated an "artificial" run on the stock exchanges, unhinged from reality, upending all known parameters of good financial sense. So what changed yesterday? On the one hand, volatility rose again. Some claim that this blocked algorithm purchases. On the other hand, as suggested by Francesco Castelli from Banor Capital, the fact that Wall Street returned to levels from the beginning of the year gave many asset managers an excuse to slightly reduce the risk in their portfolios, especially in light of the end of the six-month period. Finally, the Fed did not announce any new monetary "magic tricks" on Wednesday, meaning that profit-taking kicked off. Especially now that cases are again on the rise in the United States, throwing new uncertainty at the markets: a hypothetical second wave of the coronavirus.

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