US Equity Strategy

Selloff signal triggered, positioning less supportive

Equity Strategy

Americas

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Direction risk signal points to selloff ahead (2.7 stdev below avg)

Our directional risk signal (link) has slid to -2.7 stdev below average following the recent rally. Historically, when our signal has reached +/-1 stdev, 1mo fwd S&P returns have averaged +4% and -4%, respectively. Our model which assesses the likelihood of large up or down moves in the S&P 500 over the next month is posted every Friday along with a suite of other indicators in our Positioning and Risk Dashboard, and the link stays the same. Fundamental factors such as economic data, rates/spreads, inflation and earnings momentum have stayed large negative contributors to the tactical sell signal. Positioning/sentiment variables have turned less supportive and are closer to neutral levels - as have volatility/risk premium variables. Thus less supportive positioning/ sentiment/vol but still negative fundamentals points to further downside into year-end.

Positioning and flows signposts: not as supportive as many believe

We assess various measures of investor positioning and flows to understand how close the market may be to a bottoming vs what overhangs remain. Overall, positioning is net supportive but still mixed, with stages of flows in a bear market yet to play out.

- **Cash levels are very high but likely to move higher (+/-).** M2 cash as a % of equity+bond market cap surged toward Apr 2009 levels but declined recently as equities+bonds rallied. However, flows to institutional money market funds tend to follow changes in Fed rates with a ~12mo lag. The jump in Fed rates points to massive inflows to cash-like instruments in coming months, likely at the expense of equities. While institutional managers have raised cash, retail investors appear set to raise cash allocations with a lag once again as short rates are much higher.
- **Equity to bond reallocation still yet to play out (-)**. The ratio of equity to bond market cap, a proxy for the relative allocation real time, bottoms around the end of a bear market with 5-20pp declines in the drawdown. With the current implied allocation closer to post GFC highs and just a 3-4pp decline into the Oct lows, there is further room for allocations to move away from equities.
- **Equity MF+ETF outflows should accelerate further (-).** Total equity funds have had considerable outflows since the start of Q2 '22, after large inflows in 2021. Cumulative fund flows the last 12mo are still slightly positive compared to 12mo outflows equivalent to ~1% of S&P 500 market cap at or after market troughs.
- **Retail overhang remains, redemptions seasonally strongest in Q4 (-).** Retail investors sold on net around the summer and fall lows, but bought the dip recently. A down 2022 and higher recession risk raises the likelihood of even greater selling, with Q4/Dec seasonally the largest MF redemptions.
- **Positioning is underweight across investor types (+).** Our composite US positioning measure is now 1.5stdev below avg vs ~2stdev below at the lows as active funds added risk the last 1mo. L/S equity HFs and balanced funds are very u/w followed by CTA/macro funds. US equity MFs are u/w but non US MFs are not.
- **Future and options net positioning is very short (+).** Net speculative futures +options positioning as a % of open interest hit 10yr lows in Sep-Oct, but reversed some. Single stock+ETF short interest on the other side has not yet spiked.
- **Buybacks are slowing (-).** S&P 500 net buybacks have fallen from a $1tr run rate in Q1 '22 to ~$800bn in Q3, with Q3 buybacks down a median -16% q/q for firms that reported. Buyback flow is set to fade starting next week into a low in late Jan.

Contents

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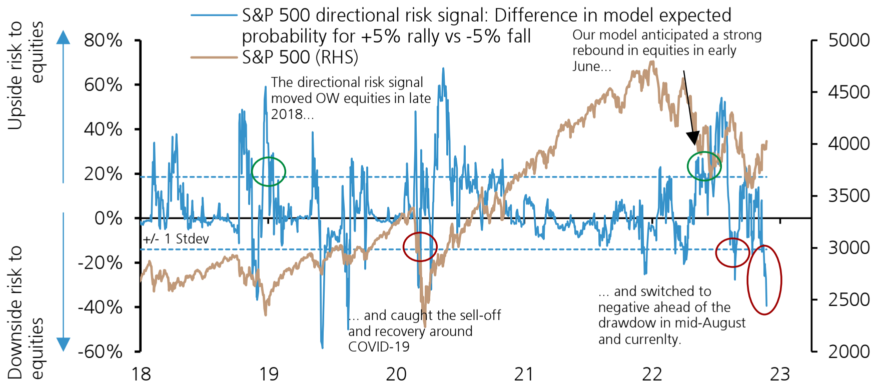
Direction risk signal turns very negative

Figure 1: S&P 500 directional risk signal

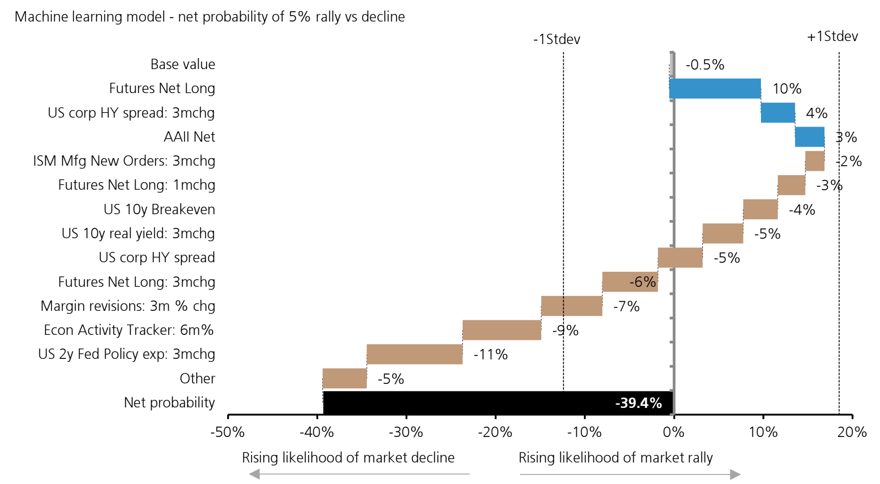


Source: Bloomberg, FactSet, UBS

Our directional risk signal is an indicator which highlights whether equities are at risk of a large near-term rally or decline ([link](#)).

Current reading: -2.7 stdev. After signalling a near-term selloff in mid-Aug and a tactical rally in Oct, the directional risk signal has turned sharply negative the last week, suggesting that the risk/reward is to the downside into year-end.

Figure 2: Breakdown of drivers of latest directional risk signal



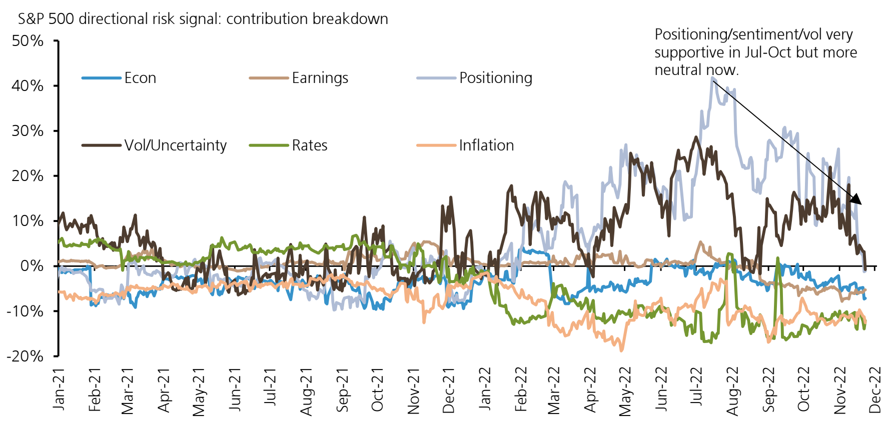
Source: Bloomberg, FactSet, UBS

We use recent developments in machine learning explainability to break down our model's predictions and identify the key drivers.

Weak economic data and earnings revisions coupled with higher rates and spreads more than offset cautious positioning and sentiment which improved recently.

Positioning less positive, growth/financial condition overhangs remain

Figure 3: Directional risk signal key drivers contribution breakdown



Source: Bloomberg, FactSet, UBS

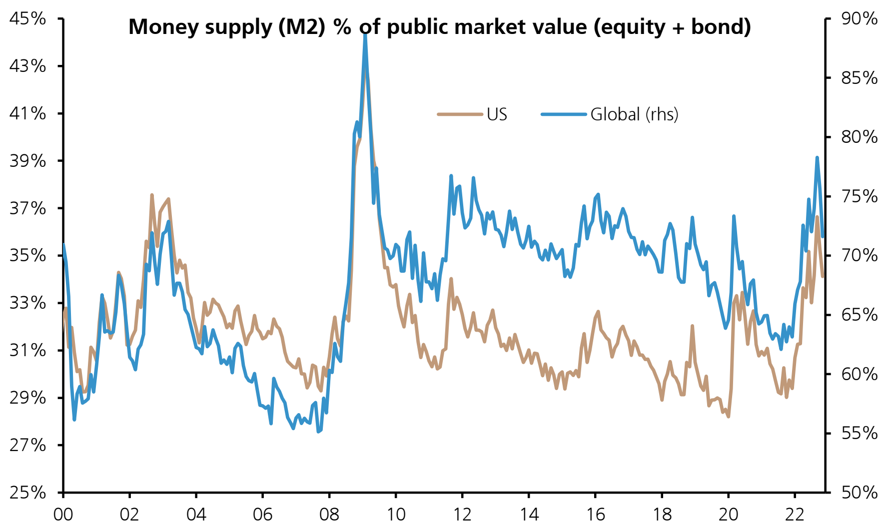
Positioning and volatility/uncertainty were the key factors driving our model expectation for a rally in early Oct. But recently the variables have turned more neutral driving down expectation for future returns.

Rates, inflations and economic condition are still a large negative in our model as overall economic conditions and earnings have turned more negative while the easing in rates/spreads/inflation was not a big improvement according to the model.

Positioning and flows: signposts for the path ahead

Cash ratios levels are very high...

Figure 4: Money supply (M2) as % of equity + bond market capitalization



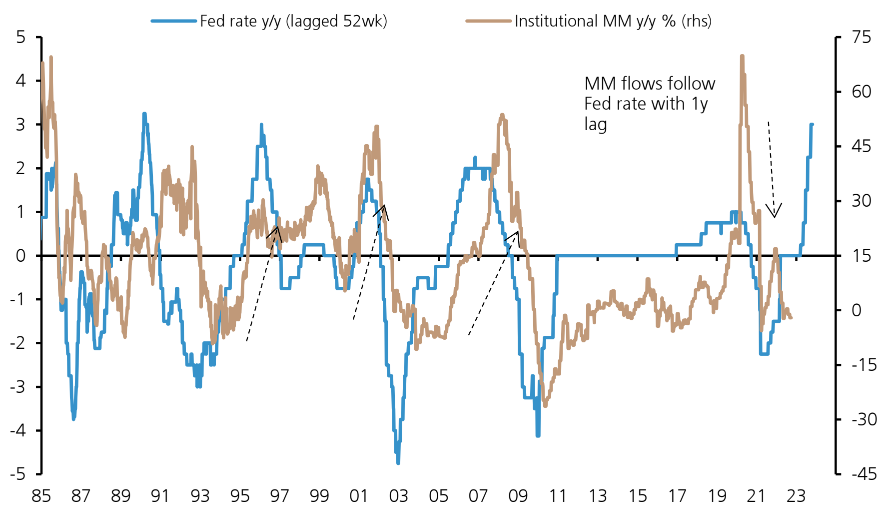
Source: Haver, Bloomberg, UBS

Money supply as a percent of equity and bond market value is a good proxy to gauge cash levels on the sidelines that can provide support for the equity market.

As asset values have fallen everywhere as yields have risen, the value of cash in M2 has surged as a ratio to bonds+equities to the highest levels since April 2009. However, as equities and bonds have rallied since Oct, the ratio has fallen back considerably

...but further flows to cash likely with higher Fed rate

Figure 5: Money market y/y change vs Fed rate y/y change



Source: Haver, UBS

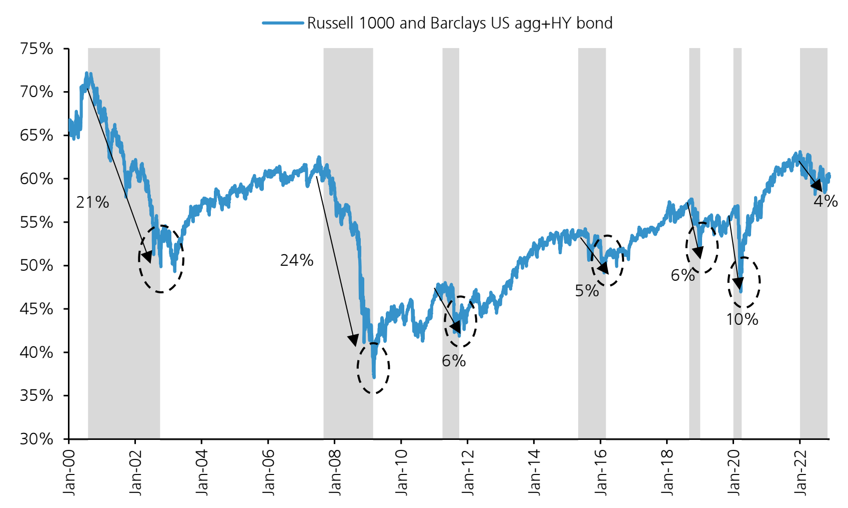
Flows to cash, as proxied by institutional money market funds, have followed the change in the Fed rate with about a 1yr lag.

The recent rate hikes point to massive inflows to money markets and similar short dated assets in coming months, which would likely be a negative for equities as a source of funds to allocate more to cash.

Equity to bond allocation has further to run

The ratio of equity to bond market values is a good real-time proxy for the relative allocation between the two. The implied equity/bond allocation bottoms around the end of a bear market with 5-20pp declines in the drawdown. With the current implied allocation closer to post GFC highs and just a 3-4pp decline into the Oct lows, there is further room for allocations to move away from equities.

Figure 6: Implied US equity vs bond allocation based on relative market value

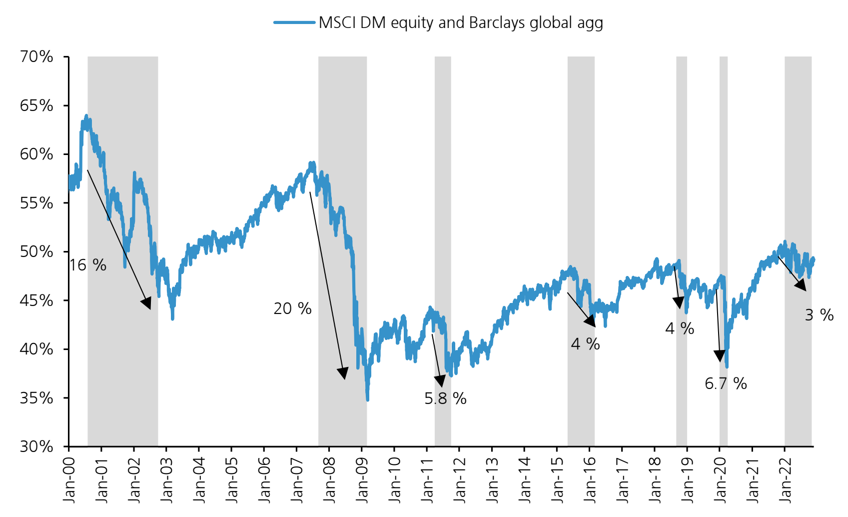


Source: Bloomberg, UBS

While cash levels are high, the market cap of equities relative to bonds in the US is still closer to the post financial crisis highs.

The implied equity allocation on average has declined by 12pp around market troughs, while the decline was more than 20pp in recession periods of 2000-2001 and 2008-2009 vs the current fall of just 4% to the recent lows.

Figure 7: Implied DM equity vs bond allocation based on relative market value

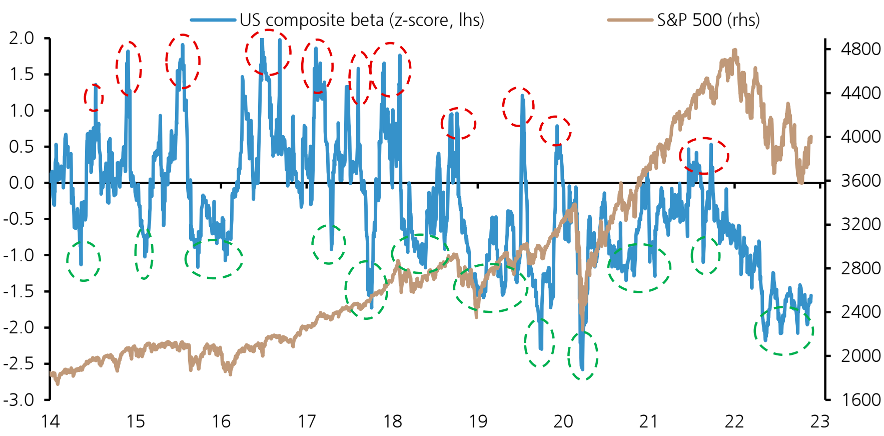


Source: Bloomberg, UBS

The implied DM equity vs DM bonds market cap has decline by nearly 3% from the beginning of the year to the Oct lows, which is a lot less than the average change of -9% around big market drawdowns.

US active fund positioning extremely u/w

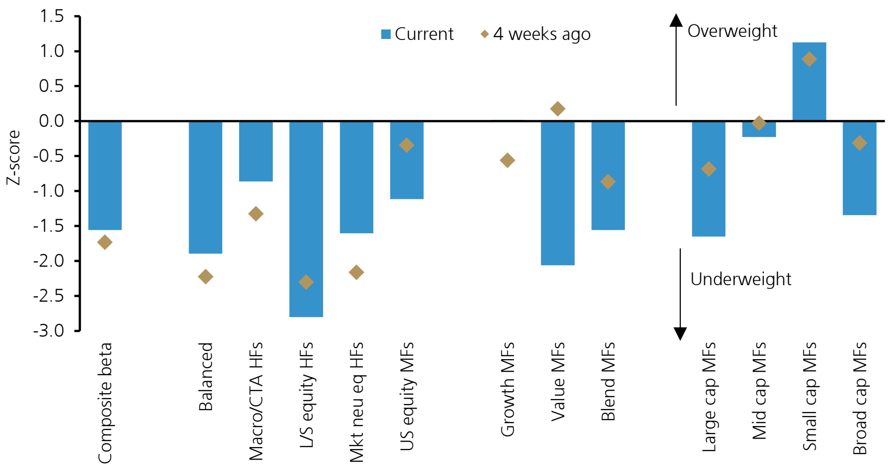
Figure 8: US active manger composite positioning (z-score)



Source: Bloomberg, UBS

Our US composite beta positioning measure is 1.5 standard deviations below average, up from the recent lows of -2 stdev below avg.

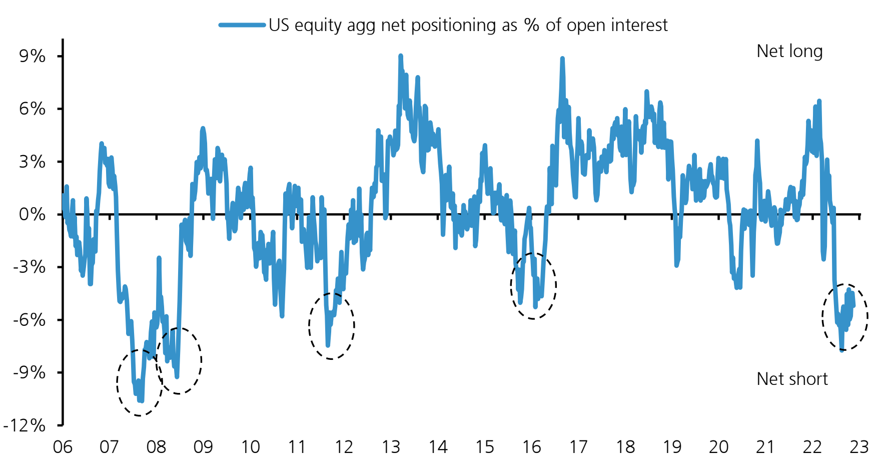
Figure 9: US active manager positioning across fund types



Source: Bloomberg, UBS

Long short equity HFs are extremely underweight with positioning more than 2.5stdev below average, followed by balanced fund and market neutral equity HFs exposure of 1.9stdev and 1.6stdev below average, respectively.

Figure 10: US equity aggregate net speculative futures and options

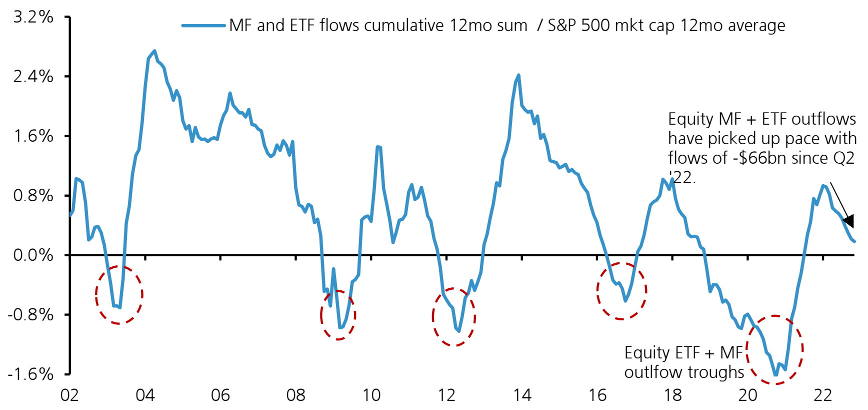


Source: Bloomberg, UBS

Net speculative positioning in US index futures and options is close to the prior lows of 2010-12, 2015-16 and 2020 though not as extreme now as 2008-09 and the recent lows.

Redemptions are likely to accelerate

Figure 11: Total equity fund flows over 12mo as a % of market cap, rolling

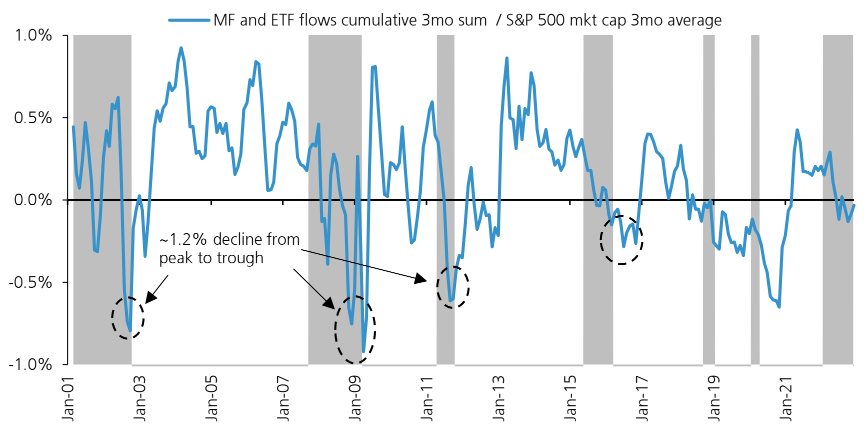


Source: ICI, Haver, UBS

Total equity funds (ETFs+MFs) have had considerable outflows since the start of Q2 '22, after large inflows in 2021.

Equity MFs+ETFs historically have seen outflows equating to about 1-1.5% of S&P 500 market cap around market bottoms. Despite recent outflows from ETFs+MF, there are likely still more redemptions to come if history repeats.

Figure 12: Total equity fund flows over 3mo as a % of market cap, rolling

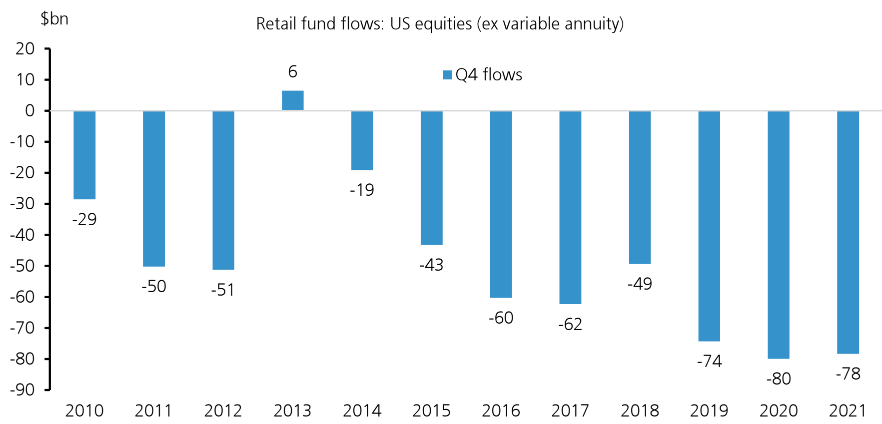


Source: ICI, Haver, UBS

3mo total equity flows as a % of market cap have declined by more than 0.5% from peak to trough around the bear market periods of 2002, 2008 and 2011.

Currently, cumulative 3mo equity flows are flat suggesting there is more room for outflows over coming months.

Figure 13: Retail flows in mutual funds during Q4

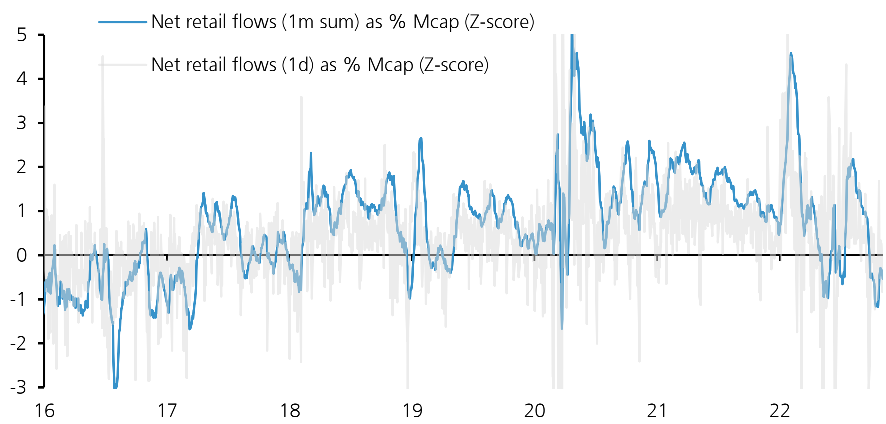


Source: ICI, Haver, UBS

Retail mutual fund flows are weakest in the 4th quarter seasonally. The selloff in 2022 raises the risk of even greater outflows into year end.

Retail selling still a large overhang

Figure 14: Retail net flows of US stocks as a share of market cap

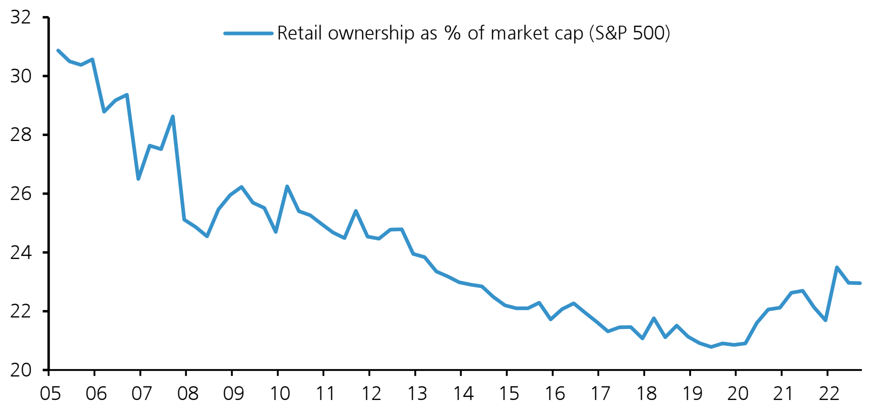


Source: Bloomberg, UBS Data Solutions, UBS

Retail net flows based on UBS RMM data have remained consistently strong since the COVID pandemic, but retail selling picked up around the market lows in 2022. There is likely more net selling to come given the massive net buying since 2020.

For further information about Retail Market Maker Flow data, please contact UBS Data Solutions at: ol-global-data-solutions@ubs.com

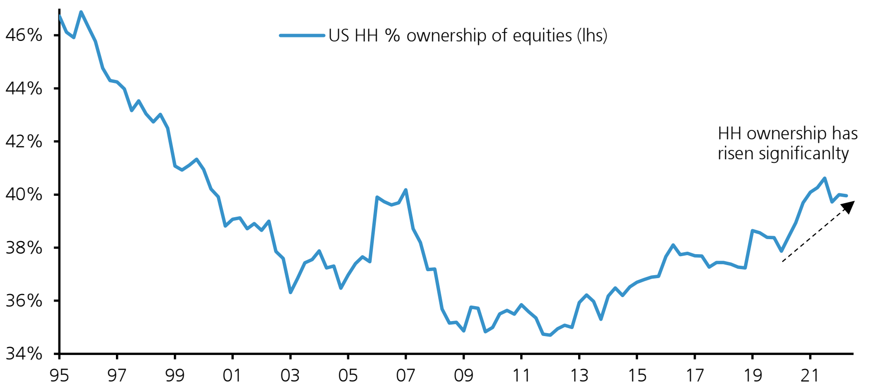
Figure 15: S&P 500 retail ownership as % of market value



Source: FactSet, UBS

The share of retail ownership of US equities bottomed in 2019 and early 2020 at around ~21% and has risen since. Currently retail owns over 23%of the S&P 500 index. Based on relative ownership, retail investors were large net sellers around market downturns in 2007-08, 2011 and late 2018 but were big net buyers in 2020.

Figure 16: US household ownership of equities

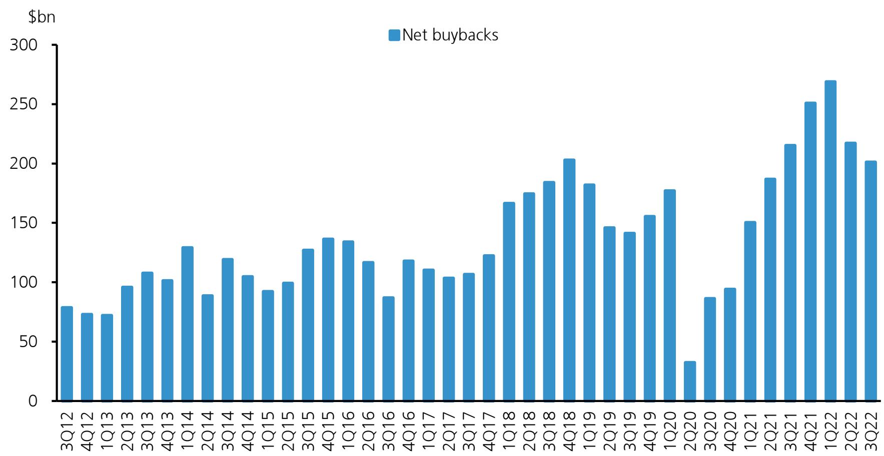


Source: Federal Reserve Board, Haver, UBS

US household ownership of equities, a proxy for retail, has risen by nearly 3pp since early 2020. After peaking in early 2021, HH ownership has remained relatively stable suggesting retail has not really been buying or selling on net. Household equity ownership collapsed from 2007-09 and fell in 2011 too.

Buybacks slowing

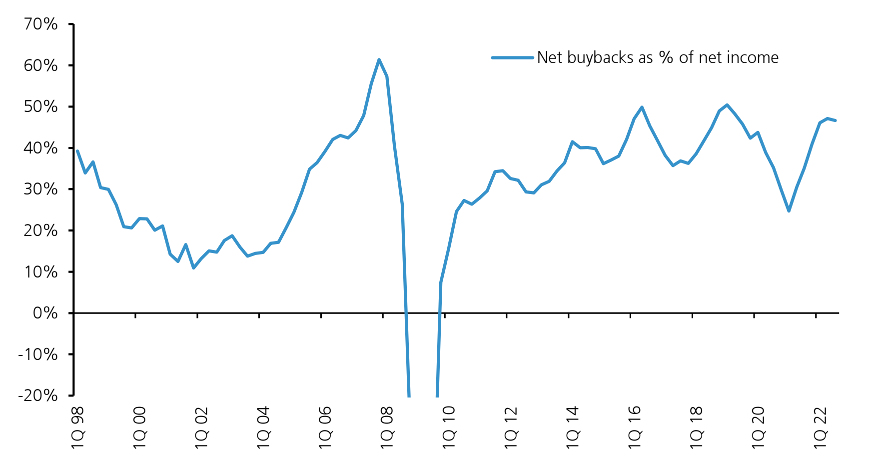
Figure 17: S&P 500 quarterly net buybacks



Source: FactSet, UBS

S&P 500 net buybacks peaked in Q1 '22 but have slowed thereafter with a net buyback run rate just above $800bn annualized for the firms that reported in Q3 vs a peak run rate of more than $1tr annualized in Q1 '22.

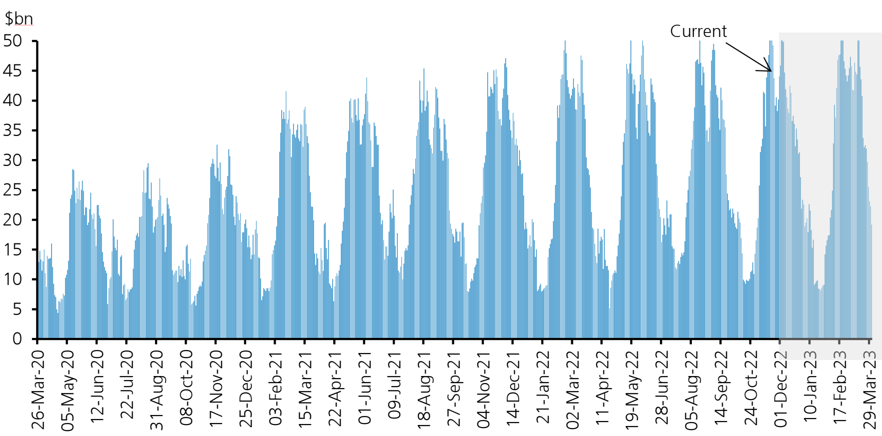
Figure 18: S&P 500 12mo trailing net buyback as % of net income



Source: FactSet, UBS

Net buybacks as a % of net income have stayed relatively flat at above average levels the last few quarters. Average buyback payout ratios point to downside for net buybacks in 2023 if/when earnings growth turns negative.

Figure 19: Corporate flow: S&P 500 net buyback plus dividends (rolling weekly, with forecast)



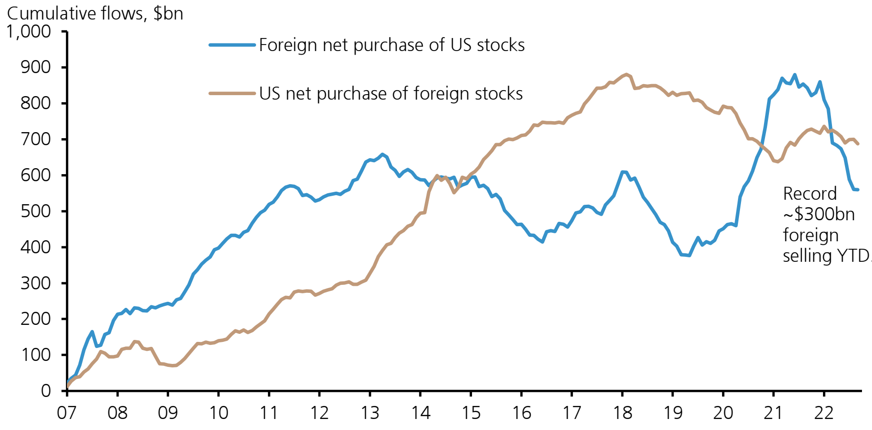
Source: Bloomberg, UBSe

Buybacks and dividends have peaked recently with corporate flows set to decline after this week to a low in late Jan.

US vs RoW equity positioning

Near-term RoW selling overhang, long-term historic RoW vs US u/w

Figure 20: Foreigners net purchases of US stocks vs US net purchases of foreign stocks - cumulative flows

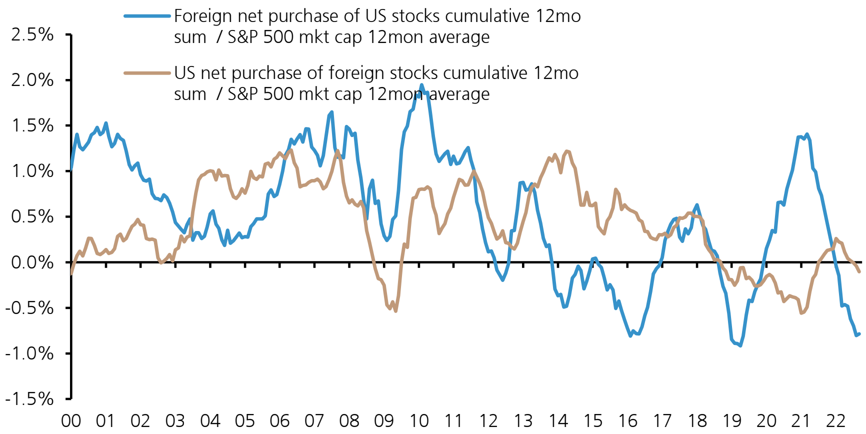


Source: Treasury International Capital , Haver, UBS

Foreign investors have sold more than $300bn of US equities YTD, reversing more than half of the massive inflows of 2020.

US investors on the other hand have only sold a small amount of foreign stocks worth of $37bn in the last six months.

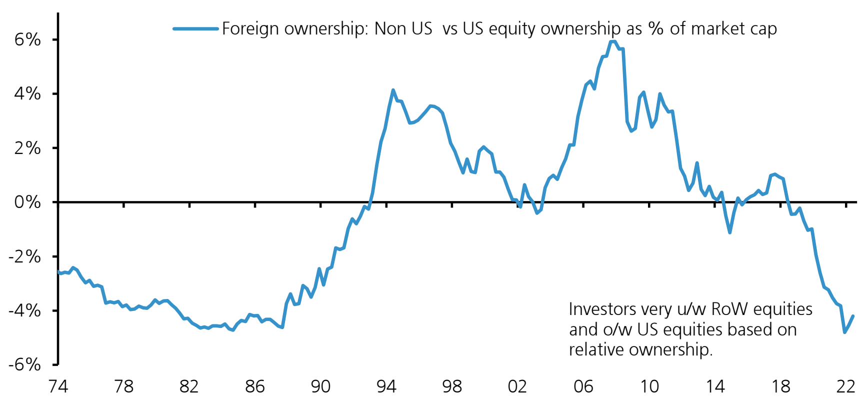
Figure 21: Foreigners net purchases of US stocks vs US net purchases of foreign stocks as % of market cap



Source: Treasury International Capital , Haver, UBS

Relative to the market cap, the magnitude of foreign selling of US stocks is nearing trough levels. Selling of foreign equities by US investors has been fairly muted.

Figure 22: US ownership of foreign equities minus foreign ownership of US equities

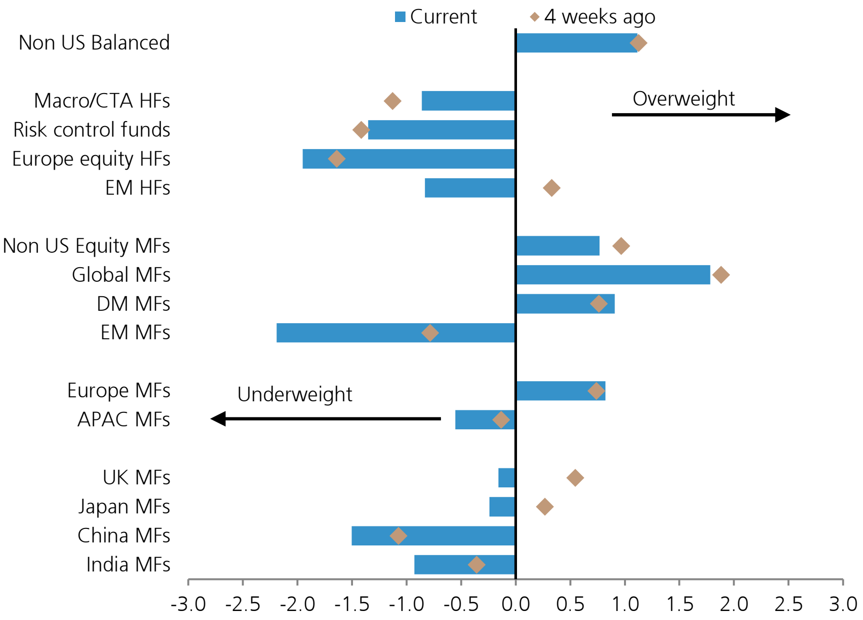


Source: Federal Reserve Board, Haver, UBS

USD outperformance and US equity outperformance has left the net position of investors very o/w US equities vs RoW equities.

Non US active MF positioning is not u/w

Figure 23: Non US active fund manager positioning

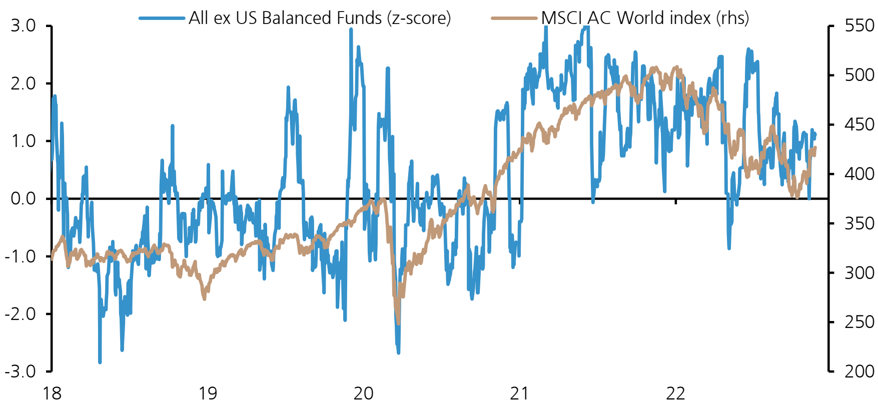


Source: Bloomberg, UBS

Non US asset allocation fund exposure is still elevated as is global, non US and DM equity MF positioning. On the other hand, HFs and EM MFs have cut exposures and are very u/w.

Europe MF exposure is notably above avg, while UK and Japan MFs positioning is slightly underweight. China and India mutual funds are significantly underweight.

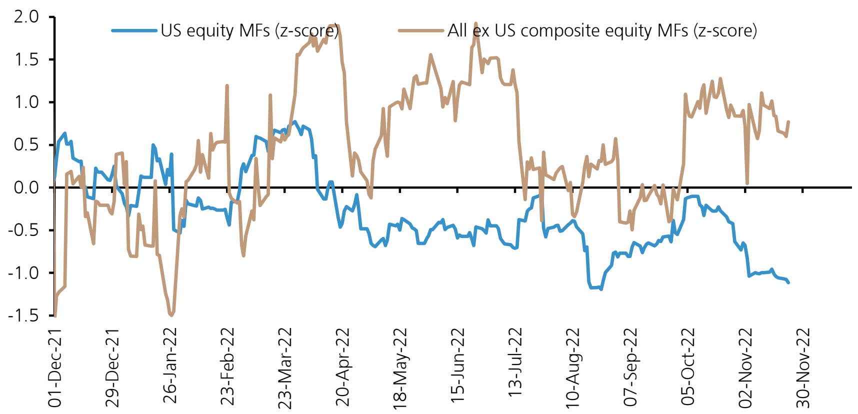
Figure 24: Non US asset allocation fund positioning



Source: Bloomberg, UBS

Non US balanced fund exposure is 1 stdev above average - and likely more more of an overhang for non-US equities.

Figure 25: US vs Non US mutual funds positioning



Source: Bloomberg, UBS

US equity mutual funds exposure is well below avg, while non US equity mutual fund positioning is well above avg.

The authors would like to thank **Mohit Jain** and **Prashant Kumar Singh**, our research support service professional, for assisting in the preparation of this research report.

Valuation Method and Risk Statement

Equity market returns are influenced by corporate earnings, interest rates, risk premia, as well as other variables influenced by the business cycle. The outlook for any and all of these variables is subject to change.

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Buy	FSR is > 6% above the MRA.	56%	26%
Neutral	FSR is between -6% and 6% of the MRA.	35%	22%
Sell	FSR is > 6% below the MRA.	9%	18%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 30 September 2022.
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