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Mo' momentum markets

Blog

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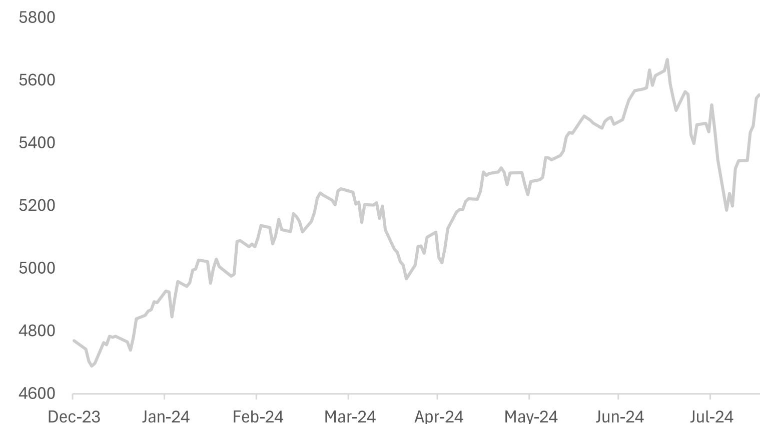
If you were on vacation for the past month and only looked at financial market levels upon returning, you would reasonably think that not much happened during your absence. Take the S&P 500, which closed on Friday at 5,554, only 2% below its all-time high set on 16 July. Yet, during the past month, the index fell 8.5% in just over two weeks, and has since rallied 7%. Comparable selloffs and rallies occurred in the VIX index and corporate credit spreads, while rates and the USD are still close to their early August lows. Even with this knowledge, one might still chalk this up as a forgettable mid-summer market swoon, largely due to positioning unwinds after a growth scare and low liquidity.

While that may accurately describe this episode, it misses the big picture, which is that these volatile moves were not anomalous, but rather a microcosm of what price action across markets has become. Market rallies/bubbles and corrections/crashes are nothing new. But markets are more prone than ever to rollercoaster swings between momentum pushing asset prices higher followed by sharp reversals, only for the pattern to repeat. That is literally what happened to the S&P 500 over the past two months, and in the spring as well (Fig. 1).

Fig. 1: Strong momentum, sharp reversals in the S&P 500

S&P 500 Index



Source: Bloomberg, UBS, as of 16 August 2024

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If financial markets are prone to whipsaw price dynamics, it raises multiple questions: Why does this happen? Are these price patterns likely to persist? Are there other implications for market pricing? And what, if anything, should investors do in response? Very brief answers are that these price dynamics are a consequence of four factors working in conjunction, they're likely to persist, they make market indexes less efficient and informative about fundamentals, and investors shouldn't overreact to such price moves, but be prepared to act quickly because attractive risk-return opportunities will arise as a result.

Four factors driving momentum/reversal price dynamics
The following four factors reflect developments in financial markets over the past two decades that collectively feed off of each other to propagate price momentum and trigger subsequent, often sharp, reversals.

Central bank influence: Monetary policy has always been influential, but its impact has grown since the global financial crisis (GFC). In addition to setting interest rates, the Fed now relies on quantitative easing (QE) and increased communication and forward guidance to either tighten or loosen financial conditions, which happens through changes in asset prices. Consequently, investors obsess over data points and Fed comments that can inform likely future policy decisions, and therefore market performance.

Macro uncertainty: Future economic activity is inherently uncertain and forecasting it became harder after the GFC and even more so after the pandemic. It's difficult to assess in real time whether activity reflects temporary cyclical factors or structural shifts in growth, inflation, and rates. The post-pandemic combination of poor data quality, normalization of activity after extreme distortions, and secular trends such as aging demographics further confounds this analysis. Consequently, views previously grounded on conventional economic models are now less well-anchored and often change quickly in response to new data. A case in point is the oscillations in market pricing for the fed funds rate in December 2025 (Fig. 2).

Fig. 2: Large oscillations in expectations for the fed funds rate
December 2025 Fed funds rate futures (in %)

Source: Bloomberg, UBS, as of 16 August 2024

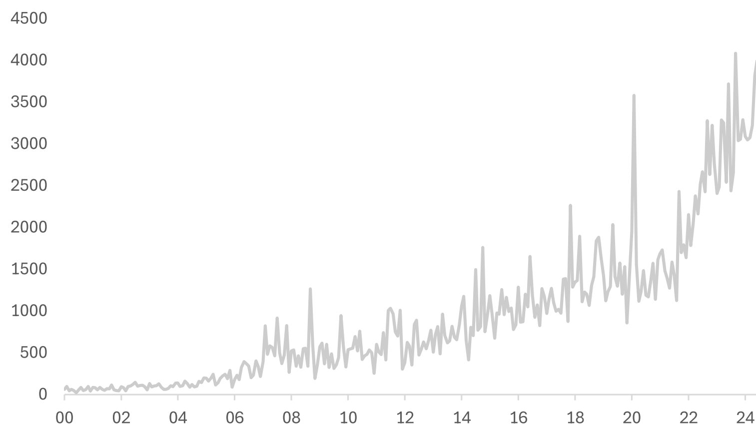
Investor herd behavior: Investors often herd into the same consensus trades—e.g., long tech, short JPY, and short volatility this year—and uncertainty and complexity amplify the incentive to do so. Cognitive

limitations cause investors to overweight recent salient information, such as the past few growth data points, and downplay abstract and technical data. Consequently, they gravitate to simple narratives—e.g., the economy is on track for a soft landing—which can quickly become consensus, especially if investors lack conviction in their macro views. Such herding can lead to price momentum, which can reverse when views quickly shift due to incoming data.

Index-linked trading: The use of index-linked products—e.g., futures, options, and ETFs based on the S&P 500—has surged over the past decade (Fig. 3). The proliferation of such products has made it easier and cheaper for investors to express market views and manage risks. The by-product of such activity is that positioning adjustments and systematic trading strategies can make markets self-reflexive, with positive and negative price momentum feeding on itself. This can cause prices to overshoot and disconnect from slower-moving fundamentals, making them susceptible to sharp reversals.

Fig. 3: Option volumes on the S&P 500 have surged

Total volume of S&P 500 index options ('000s)



Source: Bloomberg, UBS, as of 16 August 2024

Market performance this year illustrates how these factors can collectively drive momentum and reversals. All year investors have focused on when and how much the Fed will cut rates. The timing and magnitude of the cuts are data dependent, and expectations for them have oscillated because investors' low conviction on the medium-term outlook for growth and inflation. For proof, look no further than the past month when investors went from seeing a Goldilocks economy in the first half of July to rising recession fears after the July payrolls report, and now back to a soft landing after some positive growth data. It wouldn't be possible for a handful of data points to trigger each narrative flip-flop if investors didn't have low conviction in the macro outlook. Nor would the market momentum and sharp reversals happen without investors herding into consensus trades, or using index-linked products and systematic strategies to quickly express shifting views.

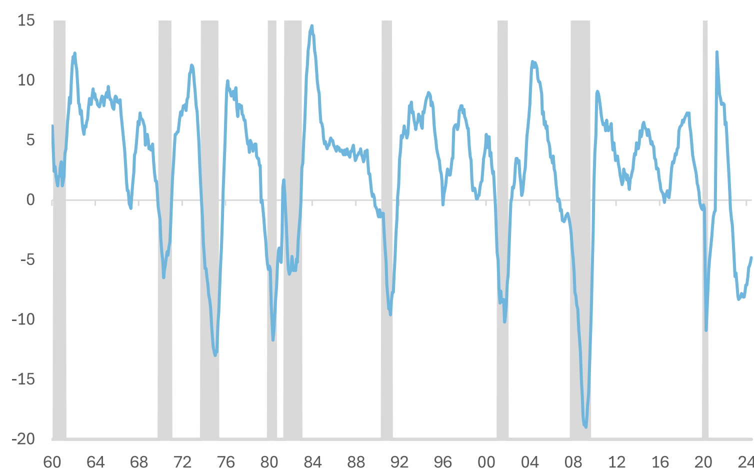
Momentum/reversal price dynamics are likely to persist

Investors should expect momentum and reversal price patterns to occur again, perhaps frequently, because these factors are likely to stay indefinitely supportive. For starters, the Fed's market influence will remain high as long as

there are growth concerns and inflation risks, and those are safe assumptions for the coming years. Aside from typical unpredictable developments, macro uncertainty is likely to stay high because of investors being less confident in their forecasting abilities. How could they not be after the consensus forecast at the start of 2023 of a second half recession proved to be wildly off the mark. Plus, previously reliable recession signals—an inverted yield curve, the leading economic indicator (LEI) turning negative, and the Sahm rule—have sent false positives for nearly two years (Fig. 4). All told, investors appear susceptible to relatively little new data triggering significant shifts in views.

Fig. 4: A negative leading indicator has failed to signal a recession this cycle

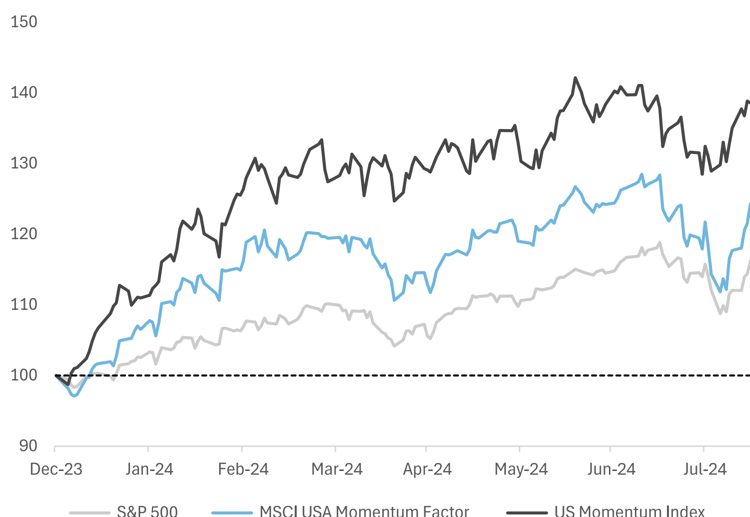
Conference Board Leading Economic Indicator, recessions shaded grey



Source: Bloomberg, UBS, as of 16 August 2024

The technical factors—positioning shifts due to investor herd behavior and systematic trading strategies, and the reliance on index-linked products—are likely to become more prevalent not less in perpetuating momentum and reversals. Unless there's a sudden change in human psychology, herd behavior and thus crowded trades will persist. Reliance on systematic strategies and index-linked products is likely to keep growing simply because they've been profitable. The momentum factor has performed better than the S&P 500 this year, with a compelling long-term track record (Fig. 5). Another profitable trade has been to sell S&P 500 volatility, which fuels momentum by suppressing volatility and encouraging investors to add risk. The combination of the Fed "put" and the tendency for volatility to rapidly mean-revert means that this trading strategy will likely continue to be widely deployed.

Fig. 5: The momentum factor has outperformed in 2024
Index = 100 as of 31 December 2023



Source: Bloomberg, UBS, as of 16 August 2024

Three other market price implications

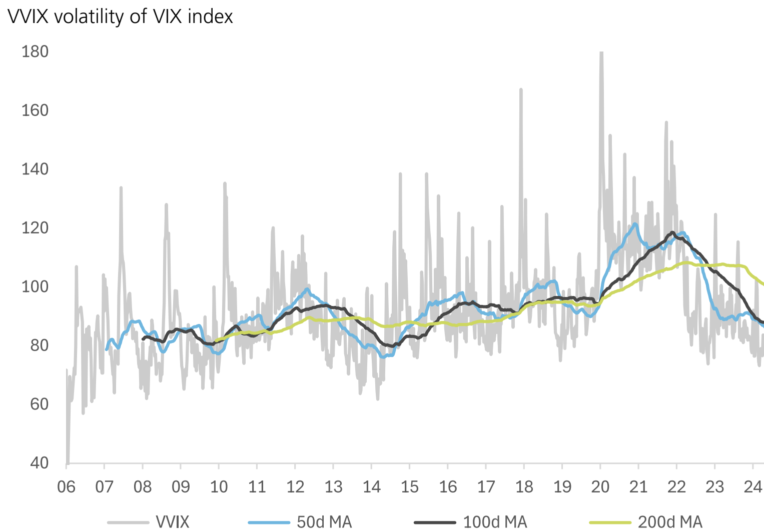
Three market pricing by-products of momentum and reversal dynamics are important to keep in mind. First, the signal-to-noise of market prices is degraded when fast moves cause prices to disconnect from economic fundamentals. For example, the recent spike in the VIX is more indicative of aggressive short covering than a signal about future economic conditions.

Second, the possibility of economic narrative flip-flops—e.g., from Goldilocks to hard landing—means that tail risks become more prominent in market pricing. This manifests not just in higher volatility, but in higher volatility of volatility because the markets have to price in a wider range of possible outcomes. The VVIX volatility of VIX index has a nearly 20-year upward trend, although it did reverse in 2022 (Fig. 6). This is consistent with equity markets being more prone to momentum and sharp reversals as they shift from pricing in one tail risk to the other.

Third, prices at the index level, like the S&P 500, that can frequently disconnect from economic fundamentals means that markets are not particularly efficient at the macro level, even as they've become more efficient at the security level over time. Such market inefficiencies create opportunities to add alpha through asset allocation rather than security selection, though neither is easy.

Fig. 6: Volatility of volatility has been trending higher until recently

VVIX volatility of VIX index



Source: Bloomberg, UBS, as of 16 August 2024

A mo' momentum investment playbook

Building on the preceding point, successful market timing is notoriously difficult, made even harder by the type of strong momentum and very rapid reversals observed over the past month. The prudent approach for most investors is to stick with a long-term strategy, based on a medium-term view of economic fundamentals. Otherwise, portfolio performance can be whipsawed even more than the markets.

Yet it's imperative to monitor these price dynamics as they can signal genuine risks and create attractive risk-return opportunities. A purely passive investing approach misses out entirely. This favors at least some active management, as price momentum and reversals can significantly alter valuations and long-run expected returns. As for what to watch to identify potential price momentum or reversals, policy changes and inflections in economic trends are often the impetus for momentum, while reversals occur when those developments are questioned. Plus, big price swings are also almost always associated with a shift in the market narrative—e.g., a soft landing is now more likely than a hard landing.

The bottom line: Strong price momentum and sharp rapid reversals as witnessed over the past month are a feature of modern financial markets, not a bug. This stems from the outsized market influence of the Fed, macroeconomic uncertainty, investor herd behavior, and the growing use of index-linked products to manage positioning. While this observation doesn't tell us anything specific that would change the medium-term fundamental outlook, it does have relevance for the investment outlook. More resilient growth data, in particular in the August payrolls report, coupled with a Fed that is cutting rates proactively, could shift the market narrative from a soft landing back to Goldilocks. Were that to occur, the market momentum of the past two weeks could continue well into the fall. A reversal would be inevitable, but that's a forecast for another day.

Appendix

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