10th February 2025

Summary

Three amber warnings for risk from Qi's Macro Factor Equity Risk Model (MFERM):

1. S&P500 returns attributable to macro have been recently fading

2. S&P500 volatility attributable to macro is more likely to rise than fall from here

3. S&P500 return correlation to idiosyncratic factors is at 2yr highs which can portend macro complacency

Details

First, for context, 5 recent facts sowing seeds of uncertainty:

- **Earnings Disappointments:** 6 of the Mag 7 have reported Q4 results so far and 5 out of those 6 have disappointed expectations. This cohort of stocks accounted for ~75% of S&P500 earnings growth last year. KWEB is +10.8% ytd vs. Nasdaq 100 +2.3%.

- **Tariff Risks:** The size of tariffs announced on Canada, Mexico and China are multiples higher than the size of tariffs imposed on Chinese goods in 2018. The initial fear of a US / China trade war then saw the S&P500 swiftly correct 9% from its local high in March 2018. Today, the S&P500 is 1.5% off ATHs.

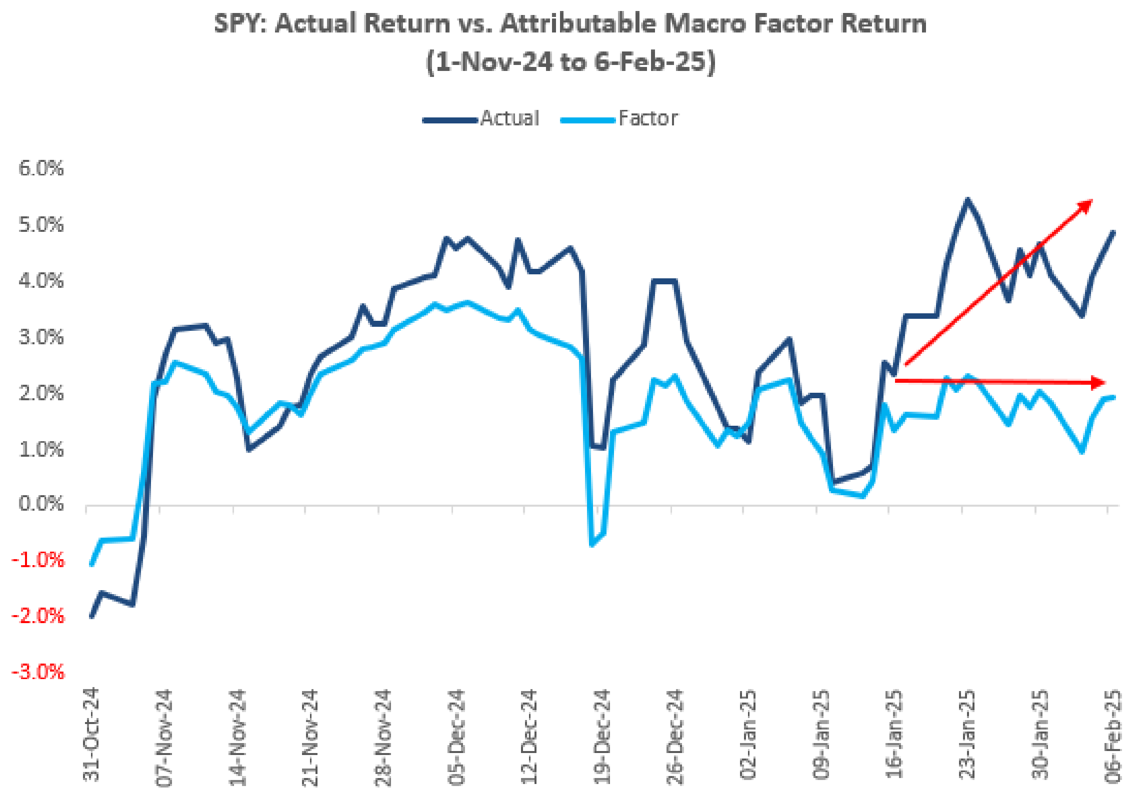
- **Recent Data:** The JPM composite global PMI survey fell in January – for the first time in four months. Feb Michigan consumer confidence also fell to 7mth lows, with inflation fears cited.

- **Policy Uncertainty:** The global economic policy uncertainty index (which scans country newspaper coverage) is now at its highest level since the height of COVID. Not seen even in Trump 1.0.

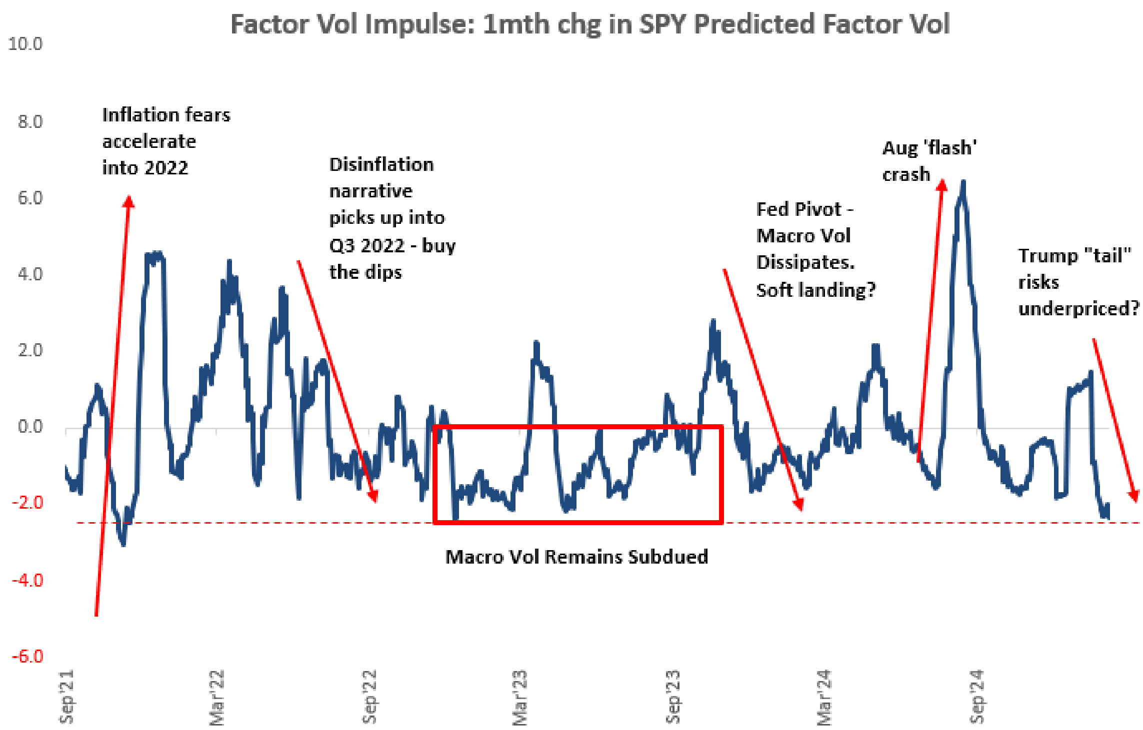
- **German Politics:** A new poll in Germany suggests it may be more difficult to form a coalition government in Germany without the Greens. The DAX is one the best performing stock markets this year despite the fact that German exports to the US have expanded massively over the last 4yrs.

In light of the above, 3 take-aways from Qi's Risk Model which indicate that the risks are underpriced:

- **Factor Return Disconnect:** Since the US election, S&P500 returns have been well explained by macro – the attributable share of returns from macro factors has been high. However, in recent weeks we have observed a disconnect between S&P500 spot returns and the attributable factor return. The move higher in recent weeks is not being supported by the macro backdrop. This, of course can reflect idiosyncratic drivers. However, given the above stated facts this divergence is unnerving.



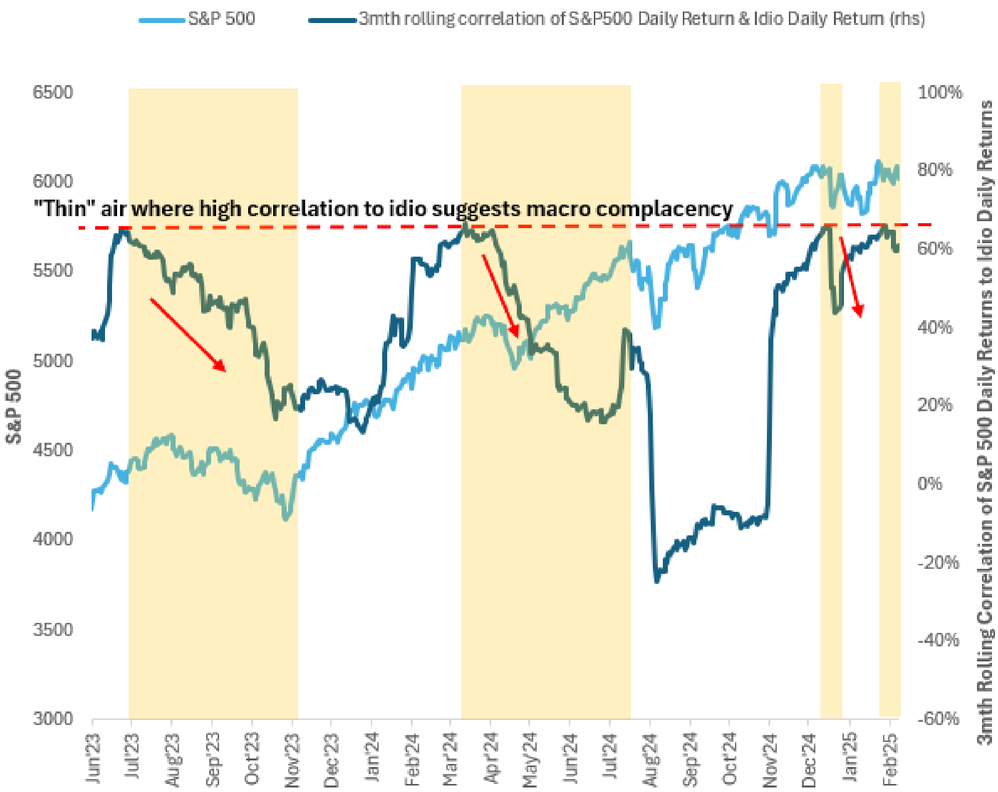
- **Factor Vol Impulse More Likely to Rise than Fall:** Mr. Market is a neurotic patient that would prefer a backdrop of macro factor stability over rising volatility. Predicted factor volatility is derived from the S&P500's factor exposures (as per Qi's MFERM) together with a factor covariance matrix. The below chart shows the 1mth rate of change in our measure of macro vol to give hints about the state of the market mindset. Falling and low = greed; Rising and high = fear. Today, this measure is at the low end of its historical range. Recent history shows it can of course remain in a low range e.g. 2023. But, 2025 faces elevated valuations and a distribution of outcomes that is still very wide.

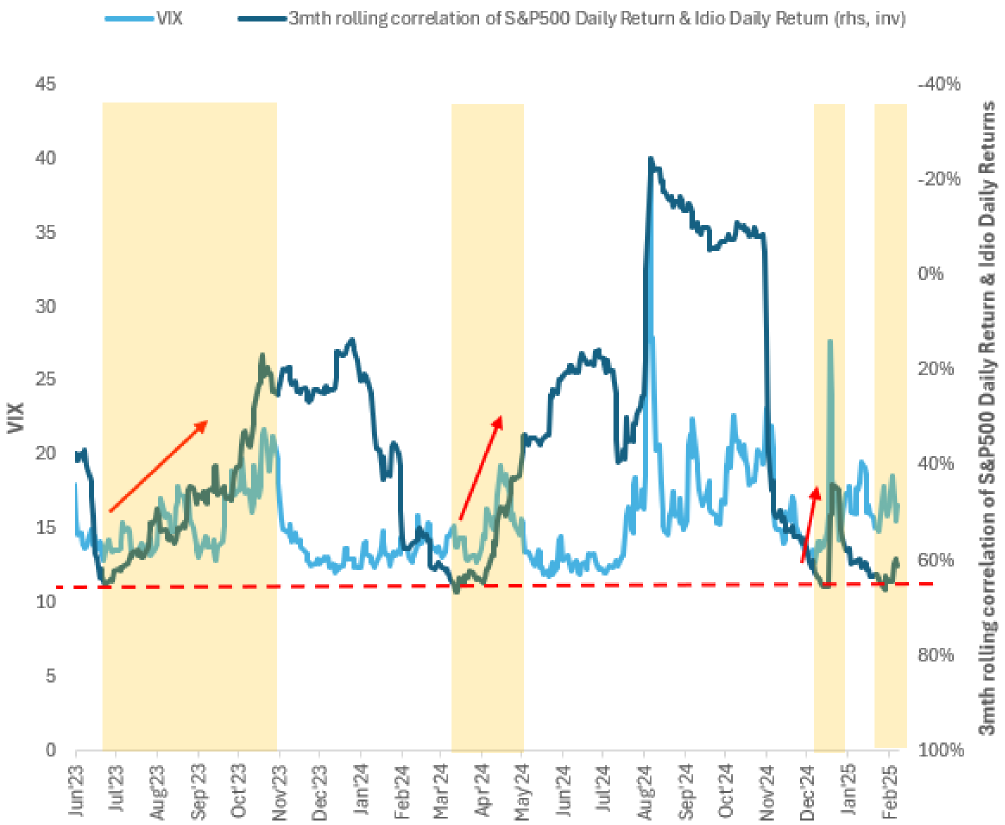


- **High correlation to Idiosyncratic Drivers can portend macro complacency:** Qi's Risk Model breaks down S&P 500 returns into macro and idiosyncratic factors. When we track the correlation between actual returns and these factors, we gain insight into the market's macro sensitivity.

- Below, we show the 3mth rolling correlation of the daily S&P 500 return to the daily return attributable to idiosyncratic factors i.e. factors which can not be explained by macro. That correlation is right at the ceiling of the last 2yrs. This was a precursor for a risk pull back / rise in volatility in the Summer of 2023, Spring of 2024 and December 2024.

- Why does this matter? High correlation to idiosyncratic factors signals potential macro complacency. When the market relies too much on non-macro drivers risk builds up and previously we have seen the tension snap.




VIX
3mth rolling correlation of S&P500 Daily Return & Idio Daily Return (rhs, inv)
45
40
35
30
25
20
15
10
5
0
VIX
-40%
-20%
0%
20%
40%
60%
80%
100%
3mth rolling correlation of S&P500 Daily Return & Idio Daily Returns
Jun'23
Jul'23
Aug'23
Sep'23
Oct'23
Nov'23
Dec'23
Jan'24
Feb'24
Mar'24
Apr'24
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