‘Buy the rumor, sell the fact?’ Not in today’s world

Recent events have shown that a strong economic backdrop trumps near-term turmoil

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There’s an old adage on Wall Street: “Buy the rumor, sell the fact.” This conveys the idea that markets tend to rise on expectations of a positive event and sell off after the event occurs. In other words, because market expectations often go too far, sentiment can cool quickly once an event actually occurs and investors move on to the next big thing.

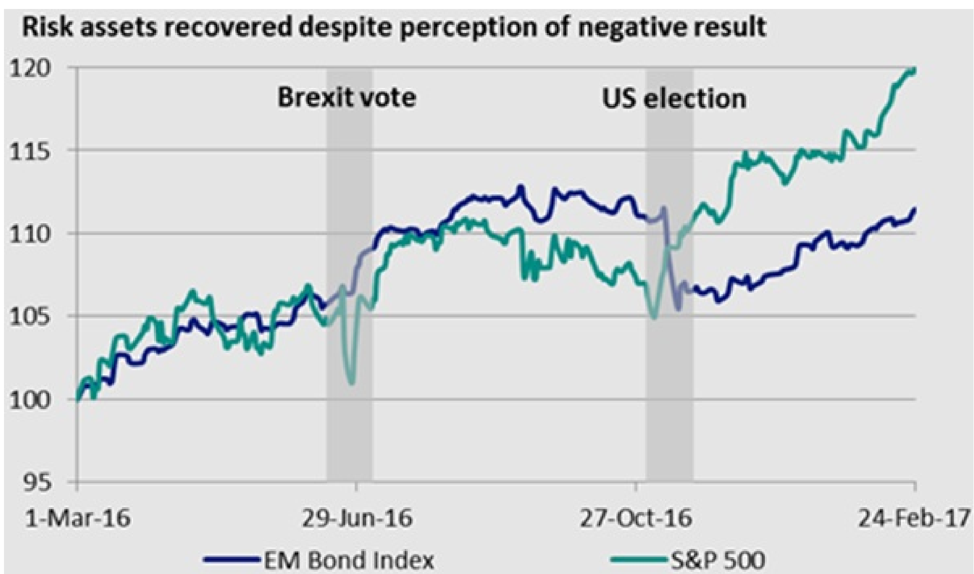
Two watershed events turn an old adage upside down

The events of the past year have put a new twist on this old axiom. In the case of both Brexit and President Donald Trump’s surprise victory in November, investors would have done well to “sell the rumor, buy the fact.”

Heading into the Brexit vote, equity markets were anxious about the possibility of Britain leaving the European Union, but did not adequately price the risk of what was – in the eyes of many investors – an undesirable outcome. As soon as the votes were counted and the unexpected outcome occurred, markets sold off sharply. But within a matter of days, markets rallied as investors’ appetite for risk returned.

Similarly, markets were skittish heading into the US elections in November, and many sold off sharply on the result. But again, within a very short period, a rally ensued. One could argue that markets had overpriced what was considered by many investors to be a risky outcome. But that doesn’t explain the sustained rally in riskier assets such as emerging market bonds, which rose sharply in the months following the event (see chart below).

Why would higher-risk assets rally when voting resulted in the more “risky” outcome?



Source: Bloomberg L.P. EM Bond Index represented by the JPM Emerging Market Bond Index Global Diversified. Past performance cannot guarantee future results. An investment cannot be made in an index.

Short-term focus can mask long-term realities
In this post-financial crisis world of heightened volatility, we at Invesco Fixed Income believe that market behavior may reflect both timing and so-called "rational expectations." While markets hate uncertainty (and these two recent events surely increased future uncertainty), market participants tend to focus on the here and now. High-profile political outcomes take time to reach fruition and even longer to affect economic outcomes. For example, it will likely take months, if not years, for the United Kingdom to leave the European Union. And the effect of President Trump's fiscal and trade initiatives will not likely be apparent for some time. Markets that move quickly past such headline-grabbing events likely recognize the long lead time before political events become economic realities.

When is an 'irrational' reaction rational?
Moreover, the recent rally in riskier assets may turn out to be rational. Despite incendiary headlines, Invesco Fixed Income believes that the global backdrop is supportive for emerging markets. Monetary policies are largely accommodative, economic growth is accelerating across much of the world, inflation is still low by historical standards, and commodity prices have stabilized.

Given this backdrop, it may indeed be rational that emerging market bonds are up nearly 6% since the post-US election sell-off and are now within striking distance of the highs set last September – as evidenced by the chart above. Risk-on sentiment can also be seen in equity valuations, which are now at all-time highs.

No one can predict how long this rally will last. Investors are coming to grips with the fact that headline-grabbing political events may take a long time to affect the relatively robust global backdrop. Until then, another market maxim, "the trend is your friend," may be more appropriate.

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